No. 81-523

Office - Supreme Court
FILED
JUL 30 1982
ALEXANDER

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

VS.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District

APPELLANT'S BRIEF ON THE MERITS

FRANKLIN C. LATCHAM
COUNSEL OF RECORD
PRENTISS WILLSON, JR.
JAMES P. KLEIER
One Market Plaza
Spear St. Tower,
34th Floor
San Francisco, CA 94105
Telephone: (415) 777-6000
Counsel for Appellant Container Corporation of America

Of Counsel
MORRISON & FOERSTER
One Market Plaza
Spear Street Tower
San Francisco, CA 94105

BOWNE-PERNAU WALSH • 190 NINTH ST. • S.F., CA 94103 • (415) 864-2300

No. 81-523

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

VS.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District

---

APPELLANT'S BRIEF ON THE MERITS

QUESTION PRESENTED

Whether requiring the income of foreign subsidiaries of a United States corporation doing business in California to be included in the parent corporation's tax base for determining the income to be apportioned to California for purposes of the California franchise tax is repugnant to the foreign commerce and due process clauses of the federal constitution, when:

1. The inclusion of the foreign subsidiaries' income in the parent's unitary tax base results in a significant distortion of the parent's taxable income and in double taxation of the foreign subsidiaries' income through misattribution of that income to California; and

2. The apportionment method used by California conflicts with the separate accounting, arm's-length method of allocation, which is an essential component of United States foreign policy; and

3. The foreign subsidiaries are organized and operating exclusively in foreign countries and are not part of a functionally integrated business with the parent and no significant property is transferred between the parent and the foreign subsidiaries.

TABLE OF CONTENTS

	Page
Question Presented	i
Opinions Below	1
Jurisdiction	1
Constitutional, Statutory and Regulatory Provisions	1
Statement of the Case	2
a. Flow of Goods Between Container and the Foreign Subsidiaries	4
b. Managerial Relationship Between Container and the Foreign Subsidiaries	4
c. Exchange of Technology	5
d. Exchange of Personnel	6
e. Loans	6
f. Centralized Services	7
Introduction and Summary of Argument	8
Argument	11
I	
Worldwide Apportionment Violates the Due Process Clause Because It Distorts Income Attribution and Produces Extraterritorial Taxation; It Violates the Commerce Clause Because It Results in Multiple Taxation of Foreign Source Income and Prevents the Federal Government from Speaking With One Voice in Regard to Foreign Policy	11
A. California's Apportionment of Income on a Worldwide, Combined Basis Results in the Taxation of Income Earned in Foreign Countries	11
1. Container's foreign subsidiaries, and foreign subsidiaries in general, operate in countries with an average wage rate significantly lower than that of the United States	12

TABLE OF CONTENTS

Page

2. Container's foreign subsidiaries, and foreign subsidiaries in general, operate at a substantially higher rate of profitability than Container itself 14

3. Because combined apportionment on a worldwide basis fails to account for the lower wage rates and greater profitability of foreign operations, such apportionment results in the extraterritorial taxation of income earned in foreign countries 15

a. Comparison of Container's Earnings Calculated by Separate Accounting and by Apportionment 16

b. Differences in Profitability Vis-a-Vis Factors 18

B. By Taxing Income Which Was Earned in Foreign Countries, and Not in California, California's Apportionment Violates the Due Process Clause 19

C. California's Apportionment of Income on a Worldwide, Combined Basis Results in the Taxation of Income Also Taxed by Foreign Countries, Thereby Violating the Commerce Clause 21

D. California's Tax Prevents the Federal Government from Speaking with One Voice in Regard to Foreign Policy, Thereby Violating the Commerce Clause 27

1. The Federal Tax System Is Based upon Separate Accounting, Deferral of Recognition of Income, and Sourcing of Income with Regard to Foreign Subsidiaries 29

2. The Income Tax Treaties of the United States Implement Federal Policy 30

TABLE OF CONTENTS

Page

3. The Worldwide Unitary Combined Reporting System, Which Imposes an Entirely Different Method of Apportioning Income upon Multinational Corporate Groups, Is in Irreconcilable Conflict with the Federal System 32

E. The Analysis Contained in the Solicitor General *Amicus* Memorandum in *Chicago Bridge & Iron* Requires Reversal of the Judgment Below 36

II

Because There Is No Substantial Operational Interdependence Between Container and Its Foreign Subsidiaries, the Due Process Clause Prohibits the Taxation of Container and the Foreign Subsidiaries as a Single Unitary Business, Regardless of Whether or Not Worldwide Formula Apportionment in General Is Permissible 40

Conclusion 49

TABLE OF AUTHORITIES CITED

Cases

Page

Federal:

ASARCO, Inc. v. Idaho State Tax Comm., ... U.S. ....., 50 U.S.L.W. 4962 (1982) 10, 40, 41, 42, 43, 44, 45, 46, 47, 48

Bass, Ratcliff & Gretton Ltd. v. State Tax Commission, 266 U.S. 271 (1924) 8, 9, 46, 47

Board of Trustees v. United States, 289 U.S. 48 (1933) 27

Butler Bros. v. McColgan, 315 U.S. 501 (1942) 46

Cooley v. Board of Wardens, 53 U.S. (12 How.) 299 (1851) 27

Evco v. Jones, 409 U.S. 91 (1972) 21, 24

Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207 (1980) 40, 41

Han's Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 (1931) 19

Hines v. Davidowitz, 312 U.S. 52 (1941) 35

International Harvester Co. v. Evatt, 329 U.S. 416 (1947) 19

Japan Line Ltd. v. County of Los Angeles, 441 U.S. 434 (1979) 9, 21, 23, 24, 25, 26, 29, 33, 34, 35, 36, 38, 39

McGoldrick v. Gulf Oil Corp., 309 U.S. 414 (1940) 35

Michelin Tire Corp. v. Wages, 423 U.S. 276 (1976) 27

Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980) 10,40

Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978) 24, 46

Norfolk & Western Ry. Co. v. Missouri State Tax Comm., 390 U.S. 317 (1968) 9, 19, 20, 45

Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920) 9, 19, 46

Wallace v. Hines, 253 U.S. 66 (1920) 19

Table of Authorities Cited

Cases

Page

Western Live Stock v. Bureau of Revenue, 303 U.S. 250 (1938) 9, 21, 22

Wisconsin v. J. C. Penney Co., 311 U.S. 435 (1940) .. 40

F. W. Woolworth v. Taxation & Revenue Dept., ... U.S. ....., 50 U.S.L.W. 4957 (1982) 10, 30, 31, 34, 41, 42, 43, 44, 45, 46, 48

Zschernig v. Miller, 389 U.S. 429 (1968) 9, 27

State:

Ash Grove Cement Co., Or. T. R. (CCH) § 203-211 (Or. Tax Ct. 1977) 47

Beecham, Inc., Appeal of, Cal. Tax Rep. (CCH) ¶ 205-635 (Cal. St. Bd. of Equalization, 1977) 32

Commonwealth v. ACF Industries, Inc., 441 Pa. 129, 271 A.2d 273 (1970) 47

Safeway Stores, Inc. v. Franchise Tax Board, 3 Cal. 3d 745, 91 Cal. Rptr. 616, 478 P.2d 48 (1970) 17

Shachihata, Inc., U.S.A., Appeal of, Cal. Tax Rep. (CCH) ¶ 206-076 (Cal. St. Bd. of Equalization, 1979) 32

U.S. Constitution

Commerce Clause, Art. I, § 8, cl. 3 1

Fourteenth Amendment, § 1 1

Statutes and Regulations

22 U.S.C. Section 2351(a) 28

22 U.S.C. Section 2351(b)(3) 28

28 U.S.C. Section 1257(2) 1

I.R.C. Section 482 30

I.R.C. Sections 551-58 29

I.R.C. Sections 861 *et seq.* 30

Table of Authorities Cited

Statutes and Regulations

	Page
I.R.C. Sections 901-04	30
I.R.C. Sections 951-64	29
Title 18, California Administrative Code, Section 25120	2, 32, 45
California Revenue and Taxation Code, Section 25101	1

Treaties

Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, March 30, 1955, United States—Italy, 7 U.S.T. 2999, T.I.A.S. No. 3679	26
Convention for the Avoidance of Double Taxation With Respect to Taxes on Income, July 22, 1954, United States—Federal Republic of Germany, 5 U.S.T. 2768, T.I.A.S. No. 3133	26
Convention with Respect to Taxes on Income and Certain Other Taxes, April 29, 1948, United States—The Netherlands, 62 Stat. 1757, T.I.A.S. No. 1855	26

Other Authorities

Address by President Reagan, World Affairs Council, Philadelphia (October 15, 1981)	27
Arthur Andersen & Co., *Tax and Trade Guide—Colombia,* (1965)	25
Arthur Andersen & Co., *Tax and Trade Guide—Italy,* (1962)	25
Arthur Andersen & Co., *Tax and Trade Guide—Germany,* (1964)	25
Arthur Andersen & Co., *Tax and Trade Guide—Mexico,* (1967)	25
Arthur Andersen & Co., *Tax and Trade Guide—The Netherlands,* (1965)	25

Table of Authorities Cited

Other Authorities

Page

Arthur Andersen & Co., *Tax and Trade Guide—Venezuela,* (1966) 25

Board of Inland Revenue, 3 *Income Taxes Outside the United Kingdom* (1967) 25

Board of Inland Revenue, 5 *Income Taxes Outside the United Kingdom,* (1967) 25

Federalist Papers No. 42 (Madison) 27

Foreign Tax Law Assoc., Inc., *Tax Laws of the World —Colombia,* (1979) 26

Foreign Tax Law Assoc., Inc., *Tax Laws of the World —Italy,* (1979) 26

Foreign Tax Law Assoc., Inc., *Tax Laws of the World —Mexico,* (1978) 26

Foreign Tax Law Assoc., Inc., *Tax Laws of the World —Netherlands,* (1979) 26

Foreign Tax Law Assoc., Inc., *Tax Laws of the World —West Germany,* (1979) 26

Foreign Tax Law Assoc., Inc., *Tax Laws of the World —Venezuela,* (1979) 26

G.A.O. *Report to the Chairman, House Committee on Ways and Means: Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving,* (1982) 20, 22, 34

Harvard University, *World Tax Series—Taxation in Colombia,* (1964) 25

Harvard University, *World Tax Series—Taxation in Italy,* (1964) 25

Harvard University, *World Tax Series—Taxation in Mexico,* (1957) 25

Harvard University, *World Tax Series—Taxation in the Federal Republic of Germany,* (1969) 25

Table of Authorities Cited

Other Authorities

Page

Hellerstein, "Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business," 21 *Nat'l. Tax J.* 487 (1968) 47, 48

Hellerstein and Hellerstein, *State and Local Taxation,* 539 (4th ed. 1978) 11

Hufbauer and Foster, "U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations," Tax Policy Research Study No. 3, Essays in International Taxation: 1976 Dept. of the Treasury (1976) 29

Income Tax Treaties: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means, 96th Cong., 2nd Sess. 61 (1980) (Statement of H. David Rosenbloom) 30

International Bureau of Fiscal Documentation, *The Taxation of Companies in Europe, Netherlands* (1977) 26

International Bureau of Fiscal Documentation, *The Taxation of Companies in Latin America, Venezuela* (1981) 25, 26

Memorandum for the United States as *Amicus Curiae, Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.,* No. 81-349 (1982) 34, 36

OECD Model Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and on Capital (1977) 1 Tax Treaties (CCH) ¶ 151 31

Petersen, "California Franchise Tax: Combined Income Report Affects Foreign Companies," 44 *J. Tax* 184 (1976) 13

Surrey "Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions," 10 *Harv. J. of Law and Policy in Int'l. Bus.* 409 (1978) 32

Table of Authorities Cited

Other Authorities

Page

Statements by Myer Rashish and Robert D. Hormats before the Subcomm. on Trade of the H. Comm. on Ways and Means (October 29, 1981) printed in *Dep't. St. Bull.*, Dec. 1981, at 44 28

Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, Hearings Before the S. Comm. on Foreign Relations, 95th Cong. 1st Sess. 28 (1977) (Statement of Laurence N. Woodworth) 29

Transcript of Oral Argument, *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349 (1982) 8, 36, 37

United Nations Model Taxation Convention Between Developed and Developing Countries, 1 Tax Treaties (CCH) ¶ 171 31

United States Model Income Tax Treaty (1981) 1 Tax Treaties (CCH) ¶ 158 31

OPINIONS BELOW

The opinion of the California Court of Appeal is reported at 117 Cal.App.3d 988, 173 Cal.Rptr. 121 (1981). The memorandum opinion and judgment of the California Superior Court are not reported. Complete texts are set forth as appendices A and B respectively to Appellant's Jurisdictional Statement ("J.S.") at A-1 and A-27.

JURISDICTION

The Court of Appeal rendered its opinion and judgment on April 14, 1981, affirming the California trial court's judgment. Appellant's petition for rehearing was filed April 29, 1981, and was denied by the Court of Appeal on May 4, 1981 (Appendix D, J.S. at A-35). Appellant's petition for hearing in the California Supreme Court was filed May 22, 1981, and was denied June 17, 1981 (Appendix E, J.S. at A-37).

A notice of appeal was filed in the Court of Appeal on July 31, 1981 (Appendix F, J.S. at A-37). The time within which to docket this appeal expired on September 15, 1981, and timely docketing was made. Probable jurisdiction was noted by the Court on May 3, 1982. The time for filing this brief was extended on June 4, 1982 to July 31, 1982. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(2).

CONSTITUTIONAL, STATUTORY AND REGULATORY PROVISIONS

Commerce Clause (Art. I, § 8, cl. 3):

> The Congress shall have power . . . to regulate commerce with foreign Nations and among the several States, and with the Indian Tribes;

Due Process Clause (Amend. XIV, § 1):

> [N]or shall any State deprive any person of life, liberty, or property, without due process of law;

California Revenue and Taxation Code, Section 25101 (during the tax years at issue, 1963-1965) provided:

> When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the State, the tax shall be measured by the net income derived from or attributable to sources within this State. Such income shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, payroll, value and situs of tangible property or by reference to any of these or other factors or by such other method of allocation as is fairly calculated to determine the net income derived from or attributable to sources within this State . . . .

California Administrative Code, title 18, section 25120(b) is set forth in Appendix G to the Jurisdictional Statement.

STATEMENT OF THE CASE

Container Corporation of America ("Container") is a Delaware corporation headquartered in Chicago, Illinois, engaged in the production and distribution of paperboard and paperboard-based packaging. In addition to its operations in the United States, during the years at issue (1963-65), Container owned controlling interests in twenty corporations organized and located in Latin America and Western Europe, the general businesses of which were the same as Container's. The Latin American operations (Colombia, Venezuela and Mexico) accounted for approximately 84% of the subsidiaries' net income. Stipulation of Facts ("Stip.") ¶ 26, Joint Appendix ("J.A.") at 15-16.[1]

---

[1]Appellant has relied on the Stipulation of Facts rather than on the lower court's opinion in summarizing the facts because the Court of Appeal misstated facts in a number of instances. For example, the Court of Appeal stated that Container made loans to its subsidiaries totalling over $18 million during the period in question. J.S. at A-4, A-10. However, the Stipulation states only that "the total *loan advances from CCA outstanding at year end* for the years at issue" were $7,704,987 for 1963, $7,155,714 for 1964, and $3,223,371 for 1965. Stip. ¶ 133, J.A. 69-70 (emphasis added). Since any advances which had been made were primarily long-term in

The operations of the foregoing subsidiaries were highly decentralized, so that the subsidiaries located in each particular country operated as fully integrated, self-sustaining business operations. Stip. ¶ 61, J.A. 30. Management of the foreign subsidiaries was comprised predominantly of citizens of the countries involved. Stip. ¶ 74, J.A. 39-40. In most of the Latin American subsidiaries, local investors held substantial minority stock interests (*i.e.*, in Colombia approximately 33% and in Venezuela approximately 20%). In nearly half of the foreign subsidiaries local representatives constituted a majority of the board of directors. Stip. ¶ 25, 78, J.A. 14, 40; Exhibit E to the Stipulation of Facts.

---

nature, the advances outstanding at year end far exceeded any advances which may have been made during a particular year. Thus, the Court of Appeal greatly exaggerates the amount of loans from Container to the foreign subsidiaries. Elsewhere, the Court of Appeal gives weight to the unsupported assertion that "the parent corporation was involved with the training of local nationals for management positions." J.S. at A-13. However, the Stipulation states that "there was no United States training program for the foreign subsidiaries' employees." Stip. ¶ 132, J.A. 69. While employees of the foreign subsidiaries occasionally visited United States operations, there is no indication that Container was involved in the training program, or that those managing the foreign subsidiaries were required to make the trips as part of their training.

Other errors typify the lack of care which the Court of Appeal employed in reviewing the facts. Thus, for example, at one point the court states that "all the foreign operations were audited by the same accounting firm that audited appellant's books," J.S. at A-9, but elsewhere acknowledges the true state of affairs, i.e., the subsidiaries in the Netherlands and Germany used their own accounting firms for audits. J.S. at A-4. The opinion also refers to 38 of Container's employees being "assigned" to foreign subsidiaries. J.S. at A-2, A-3. However, the Stipulation shows that these 38 individuals were actually employees of the foreign subsidiaries who were carried on Container's payroll as an accommodation to employees in special circumstances. Maintenance of the employees on Container's payroll required little effort, and Container was reimbursed for the service, as well as the payroll costs, by the foreign subsidiaries. Stip. ¶¶ 124-125, J.A. 64-65.

While Container's majority interest in the subsidiaries gave Container the potential for control and domination of the subsidiaries, Container did not dominate the subsidiaries, but instead left management of the businesses and control over business decisions to the subsidiaries. Stip. ¶¶ 74, 130, J.A. 39-40, 67-8. Especially within the developing countries (Colombia, Mexico, and Venezuela), prudence dictated that high profile participation by United States personnel in the local business be kept to a minimum. Stip. ¶¶ 27, 62, 130 J.A. 16, 30-31, 67-68.

(a) Flow of Goods Between Container and the Foreign Subsidiaries

Container purchased no raw materials or finished products from the foreign subsidiaries. Container did not sell any finished products to the foreign subsidiaries and sold only an insignificant amount of unfinished products to the subsidiaries. Stip. ¶¶ 26, 64, 141, 143, J.A. 15-6, 32, 73, 74. In all cases, the prices paid for unfinished products (raw materials and paperboard) were the same as Container would charge other independent purchasers, and in all cases the materials could have been obtained from sources other than Container. Stip. ¶ 141, J.A. 73.

Container and the foreign subsidiaries had no master contract or formal arrangement to make sales to customers located in both the United States and in foreign countries. There were no joint marketing efforts between Container and the foreign subsidiaries, and Container did not solicit sales for its foreign subsidiaries. Stip. ¶ 65, J.A. 32-34.

(b) Managerial Relationship Between Container and the Foreign Subsidiaries

The management of the foreign subsidiaries had complete authority and control over day-to-day business decisions. Such business decisions were not reviewed or subject to review by Container. Major policy matters, defined as consisting exclusively of capital appropriations, were also the responsibility of the foreign subsidiaries, but were

generally subject to review by Container. All other policy matters were the complete responsibility of the foreign subsidiary. Even in matters involving a major capital expenditure, the initiative rested with the foreign subsidiary, and local management reserved the right to forego initiation of previously authorized projects. Stip. ¶74, J.A. 39-49. Each subsidiary had total responsibility for its own performance. Stip. ¶¶ 127, 130, J.A. 65-66, 67-68.

During this period, Container's foreign operations staff, charged with overseeing the 20 foreign subsidiaries, consisted entirely of two full-time operations officers and three individuals, a senior executive officer, a controller, and a lawyer, who devoted part of their time to matters involving Container's investment in the foreign subsidiaries. Stip. ¶ 126, J.A. 65.

(c) Exchange of Technology

Container provided technical assistance to the foreign subsidiaries only in limited instances. For example, the foreign subsidiaries, generally either internally or with the help of independent consultants, developed their own techniques for processing raw material and for adapting machinery to different grades of paperboard. Container offered little material assistance in developing this vital technology. Stip. ¶¶ 76, 84, 85, 146, J.A. 41, 44-5, 45-6, 75-6. Similarly, Container had little or no role in the production of paperboard-based packaging by its subsidiaries, since the functional and graphic designs of the packages which Container manufactured were generally ill-suited to the products and markets served by the foreign subsidiaries. Stip. ¶¶ 56, 57, 67-70, 73, J.A. 27-8, 35-7, 39. In any event, in those instances where Container provided technical assistance to the foreign subsidiaries, the information was paid for unless prohibited by local law. Stip. ¶¶ 66, 144-146, J.A. 34-5, 74-6. Even in instances where Container had useful information, the foreign affiliates often sought assistance from local consultants, not affiliated with Container,

rather than taking advantage of existing technical services agreements with Container. Stip. ¶ 146, J.A. 75-76.

(d) Exchange of Personnel

The personnel departments of the various foreign subsidiaries, except to the limited extent discussed below, were fully independent operations and were expected to recruit and train local nationals to fill positions at every level. Stip. ¶¶ 79, 89, 95, 109, J.A. 42-3, 48, 51, 56. There was no general policy of transferring Container employees to foreign subsidiaries. Stip. ¶ 120, J.A. 62.

The number of employees who actually transferred from Container to a foreign subsidiary, or who were known to have become employed with a foreign subsidiary after having worked for Container, were few. During the period in question, only 26 former Container employees were working for foreign subsidiaries. This figure should be compared with the approximately 13,400 persons employed by Container during the same period and the 6,800 persons employed by foreign subsidiaries during the period. Stip. ¶ 119, J.A. 60-1. During the period in question, 38 employees (which includes all of the 26) of the foreign subsidiaries were also on the payroll of Container, not because of any substantive relationship with Container, but generally as a matter of convenience to employees in special circumstances. Stip. ¶ 124, J.A. 64-65.

(e) Loans

The foreign subsidiaries generally obtained financing from local sources. Stip. ¶ 133, J.A. 69-70. In certain instances, Container acted as guarantor for those loans. However, for the most part, Container had no involvement in the arrangement of such loans.

Container also made some direct loans to its subsidiaries during the period in question. The total balance of advances from Container outstanding at the end of each of the years at issue were as follows:

1963	1964	1965
$7,704,987	$7,155,714	$3,223,371

These figures compare with the following balances of outstanding loans for the foreign subsidiaries at the end of each year:

1963	1964	1965
$18,596,000	$15,497,000	$14,441,000

Stip. ¶ 133, J.A. 69-70.

(f) Centralized Services

There were no significant centralized services performed by the parent for the subsidiaries (or vice versa). The foreign subsidiaries hired their own personnel, operated their own manufacturing facilities, purchased their own supplies, and conducted their own marketing, advertising and accounting. Stip. ¶¶ 66, 88-9, 93, 95, 104, 107, 116-18, J.A. 34-35, 47-48, 50-51, 54-55, 58-59.

In rare instances Container sold used equipment to foreign subsidiaries. Stip. ¶ 147, J.A. 76-7. During the entire period in question, the total amount of such purchases by the foreign subsidiaries was less than $80,000. Exh. A-8, Joint Appendix: Exhibits ("J.A.E.") at 8.

Container also assisted the foreign subsidiaries, mainly those in Latin America, with the purchase of equipment, generally from suppliers located in the United States. In those instances Container acted only as an "independent broker" for the foreign subsidiary, for which it generally charged the subsidiary five percent of the purchase price. Stip. ¶ 148, J.A. 77. Container also acted as a broker in obtaining some waste paper for the subsidiaries. Stip. ¶ 143, J.A. 74.

• • •

During the tax years at issue, Container filed California franchise tax returns and paid franchise tax to California based on an apportioned share of its net income. The income of Container itself was $25,362,000, $28,975,000 and $30,027,000. Over Container's objection, California insisted that the income of the foreign subsidiaries be included in Container's tax base, increasing the tax base to $36,158,000,

$43,055,000 and $45,916,000, respectively. Sch. VI to Exh. 1, Stip. re Testimony, J.A. 109-13.

Container commenced this refund action on April 8, 1974, in the Superior Court of the State of California for the City and County of San Francisco. The complaint was based upon, and incorporated, claims for refund previously filed by Container and denied by the California Franchise Tax Board. The claims demanded refunds upon the ground, *inter alia*, that the state is prohibited from including these foreign subsidiaries in a unitary return with Container under the due process and foreign commerce clauses of the Constitution. Container has resisted imposition of the tax on the grounds that California's method of taxation, on its face and as applied to the instant facts, is repugnant to the foreign commerce and due process clauses of the Constitution. Both the Superior Court and the California Court of Appeal refused to grant relief from the due process and foreign commerce clause violations. The opinions of these courts are attached to the Jurisdictional Statement as Appendices A and B. The California Supreme Court denied a petition for hearing on June 17, 1981.

INTRODUCTION AND SUMMARY OF ARGUMENT

This case, together with the case of *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., et al.* (No. 81-349), represents the Court's first occasion to consider the constitutional issues arising from the application of combined apportionment to a corporation and its foreign subsidiaries on a worldwide basis.[2] An examination of these issues

---

[2] *Bass, Ratcliff & Gretton Ltd. v. State Tax Commission*, 266 U.S. 271 (1924), has no bearing on the question presented herein. That case involved an English corporation which brewed ale in England and sold it in the United States. Significantly, no question concerning a subsidiary was present because all operations were conducted by a single corporate taxpayer. Moreover, the taxpayer adduced no proof of misattribution of income to New York, the taxing state, in

(footnote continued)

reveals that California's system of unitary apportionment on a combined, worldwide basis violates the due process and commerce clauses of the United States Constitution, both inherently and as applied to the facts of this case.

Application of worldwide unitary combination to multinational corporate groups fails to meet constitutional standards in three broad areas. First, the apportionment formula frequently (including in this case) misapportions income to the United States members of the group, resulting in extraterritorial taxation in violation of the due process clause. *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S. 317 (1968); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920). Second, because the income misapportioned to the United States members of the group is fully taxed in the foreign country where it was earned, the income is subject to double taxation, in violation of the commerce clause. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979); *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938). Finally, the inconsistency of worldwide apportionment with the separate accounting, arm's-length method used by the United States and by foreign governments results in double taxation which impairs the ability of the United States to speak with one voice in carrying out its foreign policy, thereby violating the commerce clause. *Japan Line, Ltd. v. County of Los Angeles; Zschernig v. Miller*, 389 U.S. 429 (1968).

Any one of these three constitutional violations, in and of itself, requires invalidation of worldwide combination, both as a general matter and as applied to the facts of this case. The issues of distortion, double taxation and im-

---

contrast to the clear showing of distortion made in the present case. Finally, the *Bass* case was decided almost sixty years ago, before the advent of the United States tax treaty network and before development of the separate accounting, arm's-length method as a part of United States foreign policy.

pairment of federal policy are addressed in the present case in Part I of this brief.

In addition to the three constitutional problems described in the preceding paragraphs, California is prohibited from applying combined apportionment in this case because Container and its foreign subsidiaries are not parts of a single unitary business. This fact alone also prohibits combined apportionment.

The three cases in which the Court has recently considered the constitutional implications of state taxation of foreign source income (in the context of dividends from foreign subsidiaries), relate only to the unitary business issue in this case. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); *ASARCO, Inc. v. Idaho State Tax Comm.*, ... U.S. .....; 50 U.S.L.W. 4962 (1982); *F. W. Woolworth Co. v. Taxation & Revenue Dept.* ..... U.S. .....; 50 U.S.L.W. 4957 (1982). In *Mobil*, the Court approved state taxation of foreign dividends as a part of the recipient's apportionable income, only because the Court assumed that the payor subsidiaries were unitary with Mobil. Furthermore, Mobil did not introduce evidence of distortion in the apportionment formula.

In *ASARCO* and *Woolworth*, the Court prohibited state taxation of foreign dividends as part of apportionable income of the parent corporation on the ground that the subsidiaries were not part of a unitary business with the parent. The Court's opinions on the unitary issue in these two cases, especially *Woolworth*, which is strikingly similar to *Container* on the facts, are controlling precedents here and require a holding that Container and its subsidiaries are not unitary. This issue is discussed in Part II of the brief.

ARGUMENT

I

WORLDWIDE APPORTIONMENT VIOLATES THE DUE PROCESS CLAUSE BECAUSE IT DISTORTS INCOME ATTRIBUTION AND PRODUCES EXTRATERRITORIAL TAXATION; IT VIOLATES THE COMMERCE CLAUSE BECAUSE IT RESULTS IN MULTIPLE TAXATION OF FOREIGN SOURCE INCOME AND PREVENTS THE FEDERAL GOVERNMENT FROM SPEAKING WITH ONE VOICE IN REGARD TO FOREIGN POLICY

A. California's Apportionment of Income on a Worldwide, Combined Basis Results in the Taxation of Income Earned in Foreign Countries

California, through its system of worldwide unitary combination, has misallocated a substantial amount of unrepatriated foreign income, not earned in California, to California's income tax base. This misallocation occurs because the basic assumption underlying unitary combination breaks down when that system is applied to foreign operations. As a result, unitary combination, when applied on a worldwide basis, generally produces extraterritorial taxation that is unconstitutional under the due process clause.

Container itself operates entirely within the United States. Each subsidiary of Container operates entirely within a foreign country. Combined apportionment under the unitary method assumes that a dollar of property, payroll or sales of the parent (Container) produces approximately the same amount of income as a dollar of property, payroll or sales of a subsidiary. Hellerstein and Hellerstein, *State and Local Taxation*, 539 (4th ed. 1978). However, as demonstrated below, Container's principal foreign subsidiaries (and foreign operations in general) produce a greater amount of income per dollar of property, payroll and sales than the parent's United States operations. This difference in profitability is compounded by the fact that the subsidiaries operate in foreign countries where wage rates are substantially lower.

Because California's apportionment on a worldwide, combined basis necessarily ignores differences in payroll costs or profitability, it apportions income earned by the companies with lower payroll and/or greater profitability (here, the foreign subsidiaries) to the tax base of companies with higher payroll and/or lesser profitability (here, Container). Thus, the remainder of this subsection will set forth various data comparing wage rates, productivity and profitability in the United States with the foreign countries where Container's subsidiaries operate. This data forms the basis for the separate arguments made below in subsections B (distortion), C (double taxation) and D (impairment of the ability of the United States to speak with one voice in regard to foreign policy).

1. Container's foreign subsidiaries, and foreign subsidiaries in general, operate in countries with an average wage rate significantly lower than that of the United States

The costs of production in foreign countries are generally significantly lower than in the United States, primarily as a result of the lower wage rates of workers in countries other than the United States. Because wages are one of the three factors used in formulary apportionment, the use of the formula unfairly inflates the amount of income apportioned to United States operations, where wages are higher.

Although the wage rates in several of the more advanced industrial countries are, in recent years, approaching, and in some cases exceeding, those in the United States, nevertheless wage rates in the less industrialized countries remain well below those in this country. In Appendix A, at A-1, comparative wage rates compiled from United Nations sources for the years 1963-1965 show wages for underdeveloped countries at ranges between 10% and 30% of United States wages. United Nations statistics for the years 1974-1980, in Appendix B at A-3, show that while wages throughout the world are increasing, the same disparity between wages paid United States workers and those

in less industrialized countries continues to exist. Furthermore, as the United States Tariff Commission has demonstrated (see Appendix C at A-5), these differences in wage rates are not offset by lower levels of productivity for workers in various economic settings. These studies are corroborated by other sources.[3]

Container's own experience also confirms these findings. A study by Container relating to production of corrugated containers shows that the differences in productivity for 1974 were as follows:

	Cali, Colombia	All California Plants
Labor Cost per thousand square feet	$1.19	$2.85

Sch. II to Exh. 1, Stip. re Testimony, J.A. 105.

As this study demonstrates, workers in California are paid almost two and a half times the amount paid to workers in Colombia to produce the same quantity of corrugated containers. To the extent the payroll factor in Colombia consists of the wages paid to such workers, the distortion will lead directly to a misapportionment of net income. As demonstrated below, less dramatic, but similar, results occur with regard to the sales factor.

---

[3]As stated in Petersen, "California Franchise Tax: Combined Income Report Affects Foreign Companies," 44 *J. Tax* 184, 187 (1976):

> . . . wage levels are considerably lower in Japan, Italy or almost any other country than in the United States for the same work. In 1969, the cost of engineering work in Japan was only 70% of that in the U.S. (England was 75%, Holland 80%, France 90%). . . .
>
> The same type of disparity exists as to the cost of plant or property. For example, . . . in 1964-70, the average investment needed to provide employment to one person in the rubber industry in the U.S. was $137,000, while an average of only $58,000 was required outside the U.S.
>
> An apportionment of worldwide income based on property and payroll could never, under these circumstances, properly apportion the income to the local activities which produced it.

Because California's apportionment formula, as applied to the combined report, attributes income in major part (one third) upon the basis of payroll costs, the variations in wage levels have produced a substantial misapportionment of income toward California, which has the higher wage rates.

2. Container's foreign subsidiaries, and foreign subsidiaries in general, operate at a substantially higher rate of profitability than Container itself

On the average, the rate of profitability of Container's subsidiaries, particularly those in Colombia and Venezuela, is substantially higher than that of Container in the United States. Thus, Container's net income as a percentage of sales in the United States for 1963 through 1965 averaged 9.43%, while Colombia averaged 20.30% and Venezuela 22.95%. Container's net income as a percentage of invested capital averaged 13.11%, Colombia 20.51%, and Venezuela 31.56%. Sch. VI to Exh. 1, Stip. re Testimony, J.A. 109-13.

The uncontroverted testimony of Container's expert witness, Professor John C. McDonald of Stanford, confirms that because of the greater profitability of the foreign subsidiaries, the basic premise of apportionment on a combined basis breaks down when applied to foreign operations. As Professor McDonald stated, an individual U.S. company will invariably require a higher "hurdle rate" (*i.e.*, minimum anticipated rate of return on investment) for a foreign investment than for a similar domestic investment. Thus, companies expect to receive a greater rate of return on a foreign investment than on a similar domestic investment. Generally, this greater rate of return is achieved. The reasons for this include lower labor costs, more rapidly expanding economies, greater market share, governmental protection from competition, etc. J.A. 131-144, 154-167. Professor McDonald also testified that Container's "hurdle rate" and rate of profitability for its foreign subsidiaries were typical of foreign operations in general. J.A. 175-76, 186-7.

3. Because combined apportionment on a worldwide basis fails to account for the lower wage rates and greater profitability of foreign operations, such apportionment results in the extraterritorial taxation of income earned in foreign countries

Formula apportionment, when applied to the worldwide income of Container and affiliates, attributes far more income to the domestic operations of Container than Container reported for federal income tax purposes by applying the arm's-length method of accounting prescribed by the Internal Revenue Code and adopted by the international community. Correspondingly, this apportionment attributes far less income to the foreign operations of Container's subsidiaries than was earned, reported and taxed in the foreign countries in which the subsidiaries operate. This results in California's taxation of income earned not in the state, but in foreign countries.

Formula apportionment fails to recognize the variations in profitability between corporations. The profit of the total group is apportioned among the members of the unitary group according to the factors used in the formula (in California, property, payroll and sales). If the factors of the various members are approximately equal, the formula will apportion the income about equally among the members, even if actual incomes are not equal.[4]

---

[4]For example, if two corporations, one doing business exclusively in California and the other exclusively in Colombia, are combined and have the same total property, payroll and sales, formula apportionment would apportion one half of the combined income of the two companies to each, even if only one was actually profitable. Thus, even if the Colombian corporation earned $100,000 and the California corporation lost $30,000, California's apportionment on a combined basis would attribute $35,000 of income to each. Misattribution of income has also occurred in the present case, principally between Container and its Latin American subsidiaries.

(a) Comparison of Container's Earnings Calculated by Separate Accounting and by Apportionment

The magnitude of misattribution wrought by apportionment on a combined, worldwide basis can be demonstrated by comparing the income of Container from its domestic operations, as reported to the Internal Revenue Service, to the amount of income attributed to those operations by California's formula. That is to say, if one applied the three-factor formula with the numerator being domestic payroll, property and sales and the denominator being worldwide payroll, property and sales, and if the percentage produced by averaging those three fractions is multiplied by worldwide income, the result is the following increase in domestic Container income over that reported to the Internal Revenue Service for domestic Container operations:[5]

1963	1964	1965
$2,407,000	$3,996,000	$5,466,000

That leads, in turn, to an apportionment of income to California which is greater than when the base income used is domestic only, rather than worldwide. The increase in California income from the use of worldwide apportionment over the income produced by apportionment of domestic income can be shown as follows:

	1963	1964	1965
1. World-wide income apportioned to California	$3,141,635	$3,579,413	$3,523,222
2. Domestic income apportioned to California	$2,888,547	$3,139,629	$2,947,125
3. Increase of 1 over 2	$ 253,008	$ 439,784	$ 576,097

This misattribution is confirmed by a comparison of the income attributed to the various countries under a separate accounting, arm's-length analysis with that assigned

---

[5]Exhibit A to the Stipulation of Facts, J.A.E. 1-8, contains the basic data used in the calculations to prepare the following two tables.

to the countries by the use of California's apportionment formula:[6]

	Average Pre-Tax Income per Arm's-Length in Different Countries 1963/64/65	Average Pre-Tax Income per World-Wide Apportionment 1963/64/65
Container (United States)	$28,121,000	$32,068,000
Colombia	4,254,000	2,203,000
Mexico	1,605,000	1,430,000
Venezuela	4,246,000	1,907,000
Panama	1,286,000	—
Austria	(13,000)	11,000
Germany	1,793,000	2,906,000
Holland	384,000	197,000
Italy	34,000	968,000
Total Foreign	13,588,000	9,642,000
Total Combined	$41,710,000	$41,710,000

Thus, California's formula attributes an average of $4 million per year more to United States operations (and $4 million per year less to foreign operations) than the method of accounting used by the United States and the major trading countries in the world.

As the above table illustrates, the distortion produced by the formula is particularly acute between the underdeveloped and the highly-industrialized countries. For example, the apportionment formula attributes to other countries approximately one half of the income produced in Colombia and Venezuela according to the arm's-length principles applied in those countries. In Colombia's case, this produces the ludicrous result of apportioning little more pretax income to Colombia (and in some years less) than the Colombian subsidiaries paid in Colombian income taxes. The income attributed to Colombia by the California formula for the years in question is, respectively, $1,960,000, $2,454,000, $2,195,000. For the same years, the actual Colombian tax liability was determined to be

---

[6]Sch. VI to Exh. 1, Stip. re Testimony, J.A. 109-113. This method of using the California formula to determine the income attributable to the parent and subsidiary was approved by the California Supreme Court in *Safeway Stores, Inc. v. Franchise Tax Board*, 3 Cal. 3d 745, 91 Cal. Rptr. 616, 478 P.2d 48 (1970).

$2,508,036, $2,533,755, and $1,484,104, respectively. Second Addendum to Stip. ¶ 159, J.A. 83-84.

As a further example, by application of its formula California has alleged that on average for the years in issue only $197,000 of income can be attributed to the Dutch subsidiary. In fact, the Dutch subsidiary paid Dutch taxes on the basis of an average income of $384,000 per year. Actual taxes paid to the Dutch government averaged 97% of income attributed to Holland by the formula. *Id.*

(b) Differences in Profitability Vis-a-Vis Factors

The record also demonstrates the difference in the relationship between the factors and the net income produced in various countries in which Container and its subsidiaries operate throughout the world. That data is summarized in the following table which compares the relationship between dollars of sales, of payroll and of property required to produce $1.00 of net income computed for Container domestically and for Container's foreign subsidiaries in each particular country.[7]

Amount Required to Produce $1.00 of Net Income
For the Years 1963-65

Country	Payroll	Sales	Property
United States	$3.34	$10.65	$4.83
Colombia	0.27	5.17	4.74
Mexico	1.53	10.69	6.29
Venezuela	0.81	4.73	3.40
Germany	3.95	17.62	9.73
Netherlands	0.96	7.98	1.59

As can be seen from this table, the distortion in the apportionment of Container's income can be traced primarily to a dramatic difference in the relationship of payroll cost to net income in the United States as compared to other countries and to a lesser extent to a difference in the relationship of sales to net income.

---

[7]Italy is not included because the data is incomplete and because one of the Italian units was sold in 1964. These figures are derived by dividing the net income produced in each country by the respective sales, payroll, and property factors for that country. Exh. A1-8, J.A.E. 1-8, contain the basic data used to prepare this table.

B. By Taxing Income Which Was Earned in Foreign Countries, and Not in California, California's Apportionment Violates the Due Process Clause

As noted above, the primary reason that the three-factor payroll, property and sales formula is an acceptable method of dividing the taxable income of multistate enterprises among the states is that a dollar of payroll or property expended or used in one state, and a dollar of sales realized in one state, typically produce roughly the same amount of income as a dollar spent or sales made in other states. To be sure, it is recognized that there are state-by-state variations in wage and property costs that produce imprecision in apportionment, but these differences fall within the area of constitutional tolerance for "rough approximation" in the division of income from operations within the United States. *International Harvester Co. v. Evatt*, 329 U.S. 416, 422 (1947).

However, when apportionment is extended to foreign countries, wages, property costs and profits on sales vary so dramatically that the premise is no longer viable. Instead of producing a fair approximation of income earned in California, the apportionment formula results in taxation of income earned outside the state. Hence, the attempted extension of the three-factor formula beyond the borders of the United States violates the due process clause because it is "inherently arbitrary" and produces "an unreasonable result." *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120 (1920); see also *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931); *Wallace v. Hines*, 253 U.S. 66 (1920).

Even if the California apportionment formula produced a reasonable result in apportioning income between foreign and domestic operations of another taxpayer, the formula cannot be sustained here because of the substantial misattribution of income which results. As stated in *Norfolk &*

Western Railway Co. v. Missouri State Tax Commission, 390 U.S. 317, 327 (1968):

> The facts of life do not neatly lend themselves to the niceties of constitutionalism; but neither does the Constitution tolerate any result, however distorted, just because it is the product of a convenient mathematical formula which, in most circumstances, may produce a tolerable product.

The facts in many cases,[8] including this one, demonstrate that the formula leads to an unacceptable level of distortion so as to violate the due process and commerce clauses. We urge the Court to reiterate its conclusion in *Norfolk*, where, in the context of distortion resulting from the formula used by Missouri to value railroad rolling stock for property tax purposes, the Court stated as follows:

> We repeat that it is not necessary that a State demonstrate that its use of the mileage formula has resulted in an exact measure of value. But when a taxpayer comes forward with strong evidence tending to prove that the mileage formula will yield a grossly distorted result in its particular case, the State is obliged to counter that evidence or to make the accommodations necessary to assure that its taxing power is confined to its constitutional limits. If it fails to do so and if the record shows that the taxpayer has sustained the burden of proof to show that the tax is so excessive as to burden interstate commerce, the taxpayer must prevail.

Id. at 329. California has not and, as shown above, cannot carry such a burden. Thus, California cannot apportion the income of Container on a combined, worldwide basis.

---

[8] *See*, G.A.O., *Report to the Chairman, House Committee on Ways and Means: Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving* at 32 (1982) (hereinafter "G.A.O. Report").

C. California's Apportionment of Income on a Worldwide, Combined Basis Results in the Taxation of Income Also Taxed by Foreign Countries, Thereby Violating the Commerce Clause

As demonstrated above, California's system of worldwide combination apportions to California income which, under the separate accounting system adopted by the Internal Revenue Code, was earned in foreign countries. However, it is not only the separate accounting system as applied by the United States government which demonstrates that California is attempting to tax income earned in foreign countries. Rather, this same separate accounting system is used to allocate and tax income by all the foreign countries in which Container's subsidiaries operate (and, in fact, by the major trading countries of the world). As a result, California is not only taxing income which has been *earned* in foreign countries under the system of allocation applied in those countries, California is taxing income which is, in fact, also *taxed* by the foreign countries in which Container's subsidiaries operate. The resulting multiple taxation of the same income subjects foreign commerce to a burden which is not borne by intrastate commerce and is prohibited by the commerce clause. *Erco v. Jones*, 409 U.S. 91 (1972); *Western Live Stock Co. v. Bureau of Revenue*, 303 U.S. 250 (1938); *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).[9]

As the table set forth at page 17 illustrates, an average of approximately $4 million in income per year, which was taxed on a separate accounting basis in foreign countries, is apportioned to the United States, where it is

---

[9]Subsections C and D of this section of the brief show how use of worldwide unitary combination results in international double taxation and prevents the United States from "speaking with one voice when regulating commercial relations with foreign governments." As the court said in *Japan Line*, "If the state contravenes *either* of these precepts, it is unconstitutional under the Commerce Clause." 441 U.S. at 451 (emphasis added).

subject to tax again by the California formula. Some of the $4 million was actually taxed by California (Container's average California factors are approximately 10% of the total United States factors, so approximately 10% of the average income shifted to the United States was taxed by California).

More importantly, under California's theory, all of the approximately $4 million per year is subject to being taxed a second time by some state. In fact, 12 other states now use a system of apportionment almost identical to California's,[10] so that these states could also impose a multiple tax burden on the income of Container's foreign subsidiaries. Thus, the total cumulative impact of California's method of apportionment must be considered in addition to the multiple burden imposed by California itself. As Justice Stone stated in his landmark opinion setting forth the multiple taxation doctrine:

> The vice characteristic of those [taxes] which have been held invalid is that they have placed on the commerce burdens of such a nature as to be capable, in point of substance, of being imposed . . . or added to . . . with equal right by every state which the commerce touches, merely because interstate commerce is being done, so that without the protection of the commerce clause it would bear cumulative burdens not imposed on local commerce.

Western Live Stock v. Bureau of Revenue, 303 U.S. at 255-56 (citations omitted).

The multiple burdens resulting from California's apportionment formula are also illustrated by the fact that the apportionment formula attributes to other countries (principally the United States) approximately one half of the income produced in Colombia and Venezuela according to

---

[10]The thirteen states imposing worldwide combination are: Alaska, California, Colorado, Idaho, Illinois, Indiana, Massachusetts, Montana, New Hampshire, New York, North Dakota, Oregon, and Utah. *See* G.A.O. Report at 31.

the arm's-length principles actually applied in those countries. As noted above, in Colombia's case, this produces the ludicrous result of apportioning little more pretax income to Colombia (and in some years less) than the Colombian subsidiaries paid in Colombian income taxes. Also as noted above, the actual taxes paid by Container's Dutch subsidiary to the Dutch government average 97% of the income attributed to Holland by the California formula. Thus, the income of the Colombian and Dutch subsidiaries has been taxed twice—once fully in Colombia or Holland and once again in California. This is also true of the Venezuelan and Mexican subsidiaries. Second Addendum to Stip. ¶ 159, J.A. 83-84.

In the case of foreign commerce, this Court has noted an "enhanced risk of multiple taxation" which demands that state taxes be reviewed with an especially high level of scrutiny. *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434, 446-48 (1979). In *Japan Line,* the Court explained the reasons why multiple taxation resulting from differing allocation and apportionment methods may be constitutionally tolerable in dealing with state taxation of interstate commerce, but is not tolerable in dealing with state taxation of foreign commerce. In invalidating the tax, the Court stated:

> The basis for this Court's approval of apportioned property taxation, in other words, has been its ability to enforce full apportionment by all potential taxing bodies.
>
> Yet neither this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value. If a State should seek to tax the same instrumentality on an apportioned basis, multiple taxation inevitably results. Hence, whereas the fact of apportionment in interstate commerce means that "multiple burdens logically cannot occur,"

> *Washington Revenue Dept.*, 435 U.S., at 746-747, the same conclusion, as to foreign commerce, logically cannot be drawn. Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though "fairly apportioned" to reflect an instrumentality's presence within the State, may subject foreign commerce " 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids'." *Evco v. Jones*, 409 U.S., at 94, quoting *J. D. Adams Mfg. Co.*, 304 U.S. at 311.

441 U.S. at 447-48 (footnote omitted).

The Court's discussion of *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) further illustrates this point:

> [*Japan Line*], by contrast, involves no mere mathematical imprecision in apportionment; it involves a situation where true apportionment does not exist and cannot be policed by this Court at all. *Moorman*, finally, concerned interstate commerce. This case concerns foreign commerce. Even a slight overlapping of tax—a problem that might be deemed *de minimis* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned.

441 U.S. at 455-56 (footnote omitted).

In other words, the Court can assure fair apportionment in interstate commerce (thus preventing imposition of multiple tax burdens) because the Court has the power to review the formulas of all the jurisdictions levying a tax. Where apportionment formulas conflict, the Court can determine whether any one formula is "to blame," and invalidate the unfair formula. In foreign commerce, however, no tribunal exists to ensure that income earned in foreign commerce is taxed in the aggregate only once. Thus a state's apportionment method, even if (unlike here) a fair one, may subject foreign commerce " 'to the risk of

a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids'." 441 U.S. at 448.

It is clear that in this case California's apportionment must yield to the allocation made by the foreign countries in which Container's subsidiaries operate, regardless of whether a state's apportionment must *always* yield to the allocation made by a foreign government. *Japan Line* indicates that at the very least a state's formula must yield when it either results in the imposition of a multiple tax burden on foreign commerce, or the state's formula, as California's formula here and as the formula invalidated in *Japan Line*, is contrary to the custom of nations and the policy of the federal government. "California's tax . . . must be evaluated in the realistic framework of the custom of nations." 441 U.S. at 454. The foreign nations in which the subsidiaries of Container do business have the right and the power to tax the income of these subsidiaries on an arm's-length, separate accounting basis, and do so.[11] Because this taxation is consistent

[11]Container's foreign subsidiaries filed their income tax returns on a separate accounting basis. Stip. ¶ 140, J.A. 72. This method of determining the income of those subsidiaries for income tax purposes is in accordance with the laws of their respective countries as in effect during the years in issue. *See generally* Arthur Andersen & Co., *Tax and Trade Guide—Colombia*, 49-112 (1965); Arthur Andersen & Co., *Tax and Trade Guide—Italy*, 47-105 (1962); Arthur Andersen & Co., *Tax and Trade Guide—Germany*, 15-63 (1964); Arthur Andersen & Co., *Tax and Trade Guide—Mexico*, 27-75 (1967); Arthur Andersen & Co., *Tax and Trade Guide—The Netherlands*, 23-69 (1965); Arthur Andersen & Co., *Tax and Trade Guide—Venezuela*, 21-75 (1966); Board of Inland Revenue, 3 *Income Taxes Outside the United Kingdom*, 129-59 (1967) (Germany); Board of Inland Revenue, 5 *Income Taxes Outside the United Kingdom*, 213-17 (1967) (The Netherlands); Harvard University, *World Tax Series—Taxation in Colombia*, 218-36, 240-45, 335-6 (1964); Harvard University, *World Tax Series—Taxation in Italy*, 335, 354-89, 395-401 (1964); Harvard University, *World Tax Series—Taxation in Mexico*, 119-30, 139-58 (1957); Harvard University, *World Tax Series—Taxation in the Federal Republic of Germany*, 830, 2208-14, 2255-63 (1969); International Bureau of

with the custom of nations and foreign policy, California's contrary apportionment method cannot be upheld.

In *Japan Line* the Court prohibited California from taxing the containers on an apportioned basis because of the resulting double taxation of foreign commerce which the Court had no authority to limit, and because the California tax would impair the conduct of the Nation's foreign policy. Appellant submits that California is likewise prohibited from taxing the income of the foreign subsidiaries on an apportioned basis, a basis contrary to the established custom of nations, because of the resulting double taxation which this Court cannot ameliorate and because the California tax again would impair federal policy.

In short, California's use of worldwide combination on a unitary basis results in the imposition of a double tax burden on foreign commerce to which domestic commerce is not subjected and which the commerce clause forbids.

Fiscal Documentation, *The Taxation of Companies in Latin America, Venezuela*, C-3 to C-5 (1981); International Bureau of Fiscal Documentation, *The Taxation of Companies in Europe, Netherlands*, 134 (1977).

Reporting income on a separate accounting basis also accords with the tax treaties in effect between the United States and these foreign countries. Convention for the Avoidance of Double Taxation With Respect to Taxes on Income, July 22, 1954, United States—Federal Republic of Germany, art. IV, T.I.A.S. No. 3133; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, March 30, 1955, United States—Italy, art. IV, T.I.A.S. No. 3679; Convention with Respect to Taxes on Income and Certain Other Taxes, April 29, 1948, United States—The Netherlands, art. IV, §§ 1-2, T.I.A.S. No. 1855. Finally, the separate accounting, arm's-length standard is embodied in the current laws of those foreign countries. *See*, Foreign Tax Law Assoc., Inc., *Tax Laws of the World—Colombia* 9-22 (1979); Foreign Tax Law Assoc., Inc., *Tax Laws of the World—Italy* 1-6, 12-19, 38-48 (1979); Foreign Tax Law Assoc., Inc., *Tax Laws of the World—Mexico* 65-70, 162-75 (1978); Foreign Tax Law Assoc., Inc., *Tax Laws of the World—Netherlands* 1-21 (1979); Foreign Tax Law Assoc., Inc., *Tax Laws of the World—West Germany*, 23-59, 62-72 (1979); Foreign Tax Law Assoc., Inc., *Tax Laws of the World—Venezuela* 8-24 (1979).

D. California's Tax Prevents the Federal Government from Speaking with One Voice in Regard to Foreign Policy, Thereby Violating the Commerce Clause

The Framers of the Constitution clearly recognized that the federal government must have sole power in dealing with foreign nations.

> The *second* class of powers lodged in the General Government consists of those which regulate the intercourse with foreign nations, to wit, to make treaties; . . . to regulate foreign commerce . . . .
>
> This class of powers forms an obvious and essential branch of the federal administration. If we are to be one nation in any respect, it clearly ought to be in respect to other nations.

The Federalist Papers No. 42, at 279 (Madison) (J. Cooke ed. 1961).

The Court has long confirmed the preeminence of the national government in regard to foreign commerce. "In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power." *Board of Trustees v. United States*, 289 U.S. 48, 59 (1933). "[T]he Federal Government must speak with one voice when regulating commercial relations with foreign governments . . . ." *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 285 (1976).[12]

Especially since World War II, it has been the foreign policy of the United States to promote the free international flow of capital and technology to foster the social and economic progress of the United States and other nations of the world.[13] In order to promote this foreign policy

---

[12]*See also Cooley v. Board of Wardens*, 53 U.S. (12 How.) 299, 319 (1852); *Zschernig v. Miller*, 389 U.S. 429 (1968).

[13]The current administration has recently reaffirmed the long-established importance to the foreign policy of the United States of efforts to remove impediments to the free flow of trade and investment. *See*, remarks by President Reagan to the World Affairs

(footnote continued)

objective, the United States has developed a series of rules, both in the Internal Revenue Code and in its tax treaties, to provide a coherent allocation system for eliminating double taxation of multinational corporate groups. In this regard, the United States has determined that double taxation is a major impediment to its policy of promoting the free flow of capital and technology. As a United States Treasury official has stated:

> We view tax treaties as an important element in the international economic policy of the United States. One of our fundamental objectives is to minimize impediments to free international flows of capital and technology, and this objective is fostered by having the broadest possible network of income tax treaties.
>
> Among the major impediments to freer capital and technology flows are the rules of national tax systems and their interaction with the systems of other countries. Tax treaties seek to eliminate, or at least mitigate the impact of, these impediments.
>
> Treaties accomplish this minimization of impediments by a variety of means, the principal ones being the elimination or reduction of double taxation and the elimination, to the extent possible, of discriminatory

---

Council of Philadelphia, October 15, 1981, excerpted in the *N. Y. Times*, Oct. 16, 1981, § 1, at 12. *See also*, statements by Myer Rashish, Under Secretary of State for Economic Affairs, and Robert D. Hormats, Assistant Secretary of State for Economic Affairs before the Subcommittee on Trade of the H. Ways and Means Comm. on October 29, 1981, printed in *Dep't. St. Bull.*, Dec. 1981, at 44. Further, Congress has declared that it is the policy of the United States "to increase the flow of international trade" and "to encourage the contribution of United States enterprise toward the economic strength of less developed friendly countries through, [*inter alia*] private trade and investment abroad." 22 U.S.C. § 2351(a). To this end the President is directed in 22 U.S.C. § 2351(b)(3) to:

> accelerate a program of negotiating treaties for commerce and trade, including tax treaties, which shall include provisions to encourage and facilitate the flow of private investment to, and its equitable treatment in, friendly countries and areas participating in programs under this chapter.

> tax rules which distinguish unreasonably between domestic and foreign investment.[14]

Because California's method of taxation conflicts with the system set forth in the Internal Revenue Code and in United States treaties, which are used as a basis for implementing United States foreign policy, California's tax "impair[s] federal uniformity in an area where federal uniformity is essential," and hence violates the commerce clause. *Japan Line*, 441 U.S. at 448.

1. The Federal Tax System Is Based upon Separate Accounting, Deferral of Recognition of Income, and Sourcing of Income with Regard to Foreign Subsidiaries

In allocating the income of corporate members of a multinational group, the basic position of the federal system is a recognition of the separate character of each member. Thus the income of a United States member of the group is determined on a separate accounting basis, *i.e.*, by separately determining the income earned and the expenses incurred by the United States corporation. Under this method, if the parent of the affiliated group is a United States corporation, the taxable income of the parent is separately determined without taking into account the income of its foreign subsidiaries. Federal taxation of the income of the foreign subsidiaries is therefore deferred until the subsidiaries pay a dividend to the parent.[15] Double

---

[14] *Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, Hearings Before the S. Comm. on Foreign Relations*, 95th Cong., 1st Sess. 28 (1977) (Statement of former Assistant Secretary of Treasury for Tax Policy, Laurence N. Woodworth) [Hereinafter "Woodworth"].

[15] Hufbauer and Foster, "U. S. Taxation of the Undistributed Income of Controlled Foreign Corporations," Tax Policy Research Study No. 3, Essays in International Taxation: 1976, Dept. of the Treasury (1976) p. 1, *et seq.* A limited exception to deferral occurs in I.R.C. §§ 951-964 wherein shareholders are currently taxed on income of a controlled foreign corporation in certain potential "tax abuse" situations, and in I.R.C. §§ 551-558, relating to foreign personal holding companies.

taxation is eliminated by granting to United States domestic corporations credits against income taxes paid to foreign governments. I.R.C. §§ 901-904.

To ensure that the United States collects a fair share of the tax revenues from businesses engaged in foreign commerce, the Internal Revenue Service is given authority to monitor transactions between a United States corporation and its foreign affiliate. I.R.C. § 482. This system recognizes the integrity of separate corporate organizational structures in terms of their primary liability for taxes, but grants the IRS authority to reallocate any income, deduction or other item affecting taxable income among affiliated corporations, if such reallocation is necessary to determine the true taxable income of each based on arm's-length standards. Thus, the United States system is based upon and policed by the principles of separate accounting.

Coincident with the separate accounting rules are the so-called source rules—that is, the rules for determining whether and to what extent certain types of income are to be considered as derived from sources within the United States or from foreign sources. A mechanism exists at the federal level and in the tax treaties for determining the amount of foreign source income. I.R.C. §§ 861, *et seq.*

2. The Income Tax Treaties of the United States Implement Federal Policy

The separate accounting, arm's-length standard not only is the method used by the tax laws of the United States for allocating income among related taxpayers, it is also "the internationally accepted norm" for such allocation.[16] All the income tax treaties in force between the United States and the other countries of the world apply the arm's-length

---

[16]Woodworth at 33. *See also, Income Tax Treaties: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 96th Cong., 2nd Sess. 61 (1980) (statement of H. David Rosenbloom, International Tax Counsel, Department of the Treasury).

standard.[17] There are 25 such income tax treaties currently in force between the United States and other countries; 10 others are signed but not yet in effect.

Thus the federal government utilizes a series of measures for allocating and taxing income earned by corporate members of a multinational group: (i) taxation of United States members by the separate accounting, arm's-length method; (ii) deferral of taxation of the income of foreign subsidiaries of a United States parent until dividends are paid; (iii) specific sourcing of a number of items of income. These measures are designed to produce an appropriate allocation of income between the United States and foreign countries, and together with the foreign tax credit, are aimed at eliminating double taxation, thereby promoting the policy of the United States to encourage the free flow of capital and technology.

---

[17]Woodworth at 33.

The separate accounting, arm's-length standard is embodied in the model convention proposed by the OECD (Organization for Economic Cooperation and Development) of which there are 24 members, including the United States. Article 9(1), OECD Model Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and on Capital (1977), 1 Tax Treaties (CCH) ¶ 151 (hereinafter "OECD Model Convention"). On June 16, 1981, the Treasury Department released its revised draft of the United States Model Income Tax Treaty which also adopts the separate accounting, arm's-length standard. As with most recently concluded United States tax treaties, the new model closely follows the OECD Model Convention. *See*, United States Model Income Tax Treaty (June 16, 1981), Article 9(1), 1 Tax Treaties (CCH) ¶ 158; *see also* the treaties between the United States and other countries cited in Appendix A to the brief *amicus curiae* of the Confederation of British Industry filed in this case, all of which adopt the arm's-length standard. The United Nations' model treaty also provides for use of the separate accounting, arm's-length standard. United Nations Model Taxation Convention Between Developed and Developing Countries, Article 9(1), 1 Tax Treaties (CCH) ¶ 171.

3. The Worldwide Unitary Combined Reporting System, Which Imposes an Entirely Different Method of Apportioning Income upon Multinational Corporate Groups, Is in Irreconcilable Conflict with the Federal System

Under the unitary system, when an enterprise doing business in California is part of a group carrying on a "unitary business" under California's rules, a combined report of the group's worldwide income is required.[18] Where multinational business operations are concerned, California does not limit its requirement of a combined report to enterprises in which the parent corporation is headquartered in California or the United States.[19]

California's method of taxation completely contravenes the three basic tenets of the federal system outlined above.[20] The assumption underlying the combined unitary reporting system is that the income of affiliated corporations which are members of a "unitary group" cannot be determined by separate accounting and that intercompany charges cannot be adequately established. Furthermore, the unitary system immediately includes the income of the foreign subsidiaries of United States parents in the apportionable base and does not recognize the necessity of sourcing various items of income.

These substantial theoretical differences are matched by equally significant differences when the two systems of taxation are put into actual practice. For example, the federal system recognizes the simple fact that a corporate member of an affiliated group operating in one country can be more profitable than another member of the same

---

[18]Title 18, California Administrative Code, § 25120.

[19]*Appeal of Beecham, Inc.*, Cal. Tax Rep. (CCH) ¶ 205-635 (Cal. St. Bd. of Equalization, 1977); *Appeal of Shachihata, Inc., U.S.A.*, Cal. Tax Rep. (CCH) ¶ 206-076 (Cal. St. Bd. of Equalization, 1979).

[20]Surrey, "Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions," 10 *Harv. J. of Law and Policy in Int'l Bus.* 409, 415-16 (1978).

group operating in another country. Unitary apportionment denies that fact. Under the unitary approach, the profit of the total group is apportioned among its members according to the factors used in the formula. As discussed above, at page 15, if some members are in fact more profitable with regard to the apportionment factors than others, the income of the more profitable members will be apportioned to those with lesser profit, or no profit at all.

Thus, the federal system and the unitary system are in sharp conflict both in theory and in result. Furthermore, since the foreign governments of the world have also adopted the separate accounting, arm's-length standard for apportioning the income of multinational affiliated corporations both in their internal laws and in their tax treaties, California's use of the unitary system obviously conflicts with their system of apportionment and, as discussed at pp. 21-26 above leads to double taxation.

The resulting conflicts between specific allocation and apportionment were discussed by the Court in *Japan Line:*

> A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an *asymmetry* in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such *retaliation* of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. *If other States followed* the taxing State's example, various instrumentalities of commerce could be subject to varying degrees of multiple taxation, a result that would plainly prevent this Nation from "speaking with one voice" in regulating foreign commerce.

441 U.S. at 450-51 (footnotes omitted and emphasis added).

The application of these principles to this case is striking. California's novel unitary approach creates an asymmetry in the international tax structure, since the custom of nations has been to determine taxable income based on separate accounting.[21] This point has been emphasized many times recently in diplomatic communications which the United States Treasury and State Departments have received from foreign governments. See Appendices 1a-9a of the United States Memorandum as *amicus curiae* in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349. More recent communications from Canada and the ten European Community governments are attached hereto as Appendices D and E at A-6 and A-8. Thus, California, like Los Angeles County in *Japan Line*, has imposed upon the international community a dramatically different method of taxation, thereby creating a climate where "international disputes over reconciling apportionment formulae may arise." 441 U.S. at 450. Furthermore, retaliation could easily take place. For example, a recent debate in the British Parliament discussed the possibility of Great Britain retaliating against the California system by imposing the worldwide unitary method upon United States corporations with subsidiaries in Great Britain.[22]

The Court's sentence beginning with the phrase "if other states followed . . ." quoted above is particularly appropriate since at least 12 other states have already followed California's lead. As a result, the ability of the United States to speak with one voice has been increasingly impaired, inasmuch as the states have not agreed, *inter alia*, upon a uniform tax base, a uniform definition of a unitary business, or uniform apportionment formulas.[23]

---

[21]"In this connection I would note that the arm's-length standard is the internationally accepted norm for apportioning income between related taxpayers. It is confusing to other countries and *disconcerting to international relations* when our states use a different standard." Woodworth at 33 (emphasis added).

[22]House of Commons, *Official Report*, 27 April 1982, vol. 22, No. 105, c. 823-8.

[23]G.A.O. Report at 12-21.

It is true that Congress has not established a particular system which states must follow in determining income earned within the state from foreign commerce. Nor has Congress expressly prohibited the states from employing the unitary method for determining the taxable income of a business engaged in foreign commerce. Nevertheless, this Court has invalidated state legislation in conflict with federal policy even in the absence of an express federal statute. The test, as stated in a case passing on a Pennsylvania statute, is as follows:

> Our primary function is to determine whether . . . Pennsylvania's law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.

Hines v. Davidowitz, 312 U.S. 52, 67 (1941). A similar test was applied in *McGoldrick v. Gulf Oil Corp.,* 309 U.S. 414 (1940), where the Court invalidated a New York City sales tax imposed on sales of fuel oil to ocean-going vessels on the ground that the tax was in conflict with federal policy.

This test was also applied in *Japan Line,* which presents the closest analogy to the present case. In that case the Court invalidated a county property tax on the ground that the levy would frustrate federal policy, even though there was no federal statute or treaty explicitly so providing. The applicable treaty involved exempted from federal taxes and customs duties containers owned by foreign based corporations as long as the containers, while in the United States, were used solely in foreign commerce. Although the treaty pertained only to federal taxes (as is true with the income tax treaties in this case), the policy of the United States was clear. The containers were to be exempt from taxes and duties while in the United States, thus leaving taxation of the containers solely to the country of the owner's domicile and eliminating double taxation. The Court held that Los Angeles County's tax was an obvious impairment of the federal policy established to eliminate double taxation in this area.

In regard to Container, to the extent that the unitary method produces an amount of taxable income for Container's United States operations which exceeds the amount determined on an arm's-length basis (which is true for each of the years in issue, see p. 16, *supra*), necessarily California taxes foreign source income as that term has been defined for federal income tax purposes. Since no California tax credit or deduction is available for foreign taxes paid on this income, double taxation of such income is inescapable. Such improper apportionment of income and resulting double taxation unavoidably frustrate the United States foreign policy of promoting the free international flow of capital and technology and therefore violates the commerce clause.

E. The Analysis Contained in the Solicitor General's Amicus Memorandum in Chicago Bridge & Iron Requires Reversal of the Judgment Below

Last Term in *Chicago Bridge & Iron* the Solicitor General filed an *amicus* memorandum at the behest of the Departments of State and Treasury, the Department of Commerce (acting at the request of the Delegation of the Commission of the European Communities) and the United States Trade Representative. In that memorandum, the Solicitor General urged that the imposition of a comparable Illinois income tax on the apportioned combined worldwide business income of a unitary group of related corporations violated the Commerce Clause. Since the Court has restored that case to the calendar for reargument without setting it in tandem with the argument in the instant case, we have reproduced the salient portions of the United States memorandum for the convenience of the Court in the Appendix, at A-10. Indeed, given the Solicitor General's explicit suggestions, later reinforced by our own motion, that the Court note probable jurisdiction here in order to consider the question "in the context of a case involving multiple taxation in fact," Appendix F at A-20, Appellant believes that his memorandum is highly pertinent to the disposition of this case as well.

The analysis contained in the Solicitor General's *amicus* memorandum in *Chicago Bridge & Iron*, in the context of the facts of this case, requires reversal of the judgment below. The Solicitor General relied upon *Japan Line* as the "seminal decision" (*Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349 Transcript of Oral Argument, April 19, 1982, at 16 ["Tr."]) that "undermines the basis of the decision below and invalidates the unitary apportionment method as applied to multinational corporate groups," Appendix F at A-14 (foonote omitted). As the memorandum stated, *id.* at A-17:

> We submit that analysis of the Illinois tax under the principles of *Japan Line* requires the conclusion that the combined apportionment method, applied to a unitary business with foreign corporate constituents, is barred by the Commerce Clause. Like the ad valorem tax at issue in *Japan Line*, the Illinois tax violates both precepts discussed in that decision insofar as it creates a substantial risk of international multiple taxation and impairs federal uniformity in the conduct of foreign relations.

Thus, the Solicitor General identified the two grounds upon which the Court rested its decision in *Japan Line*: "first, as the Court said, the enhanced risk of multiple taxation, and second, the need for federal uniformity in the conduct of international relations and foreign trade." Tr. 16.

Here, as Container has pointed out (*supra*, at 21-26), the application of the California tax in this case does not simply create a risk of multiple taxation but "creates multiple taxation in fact." *Japan Line*, 441 U.S. at 452, n.17. In these circumstances, as the Solicitor General observed, Appendix F at A-19:

> both the state and the foreign country would tax such apportioned income, thereby resulting in international double taxation of the same income. In this manner, the state unitary method frustrates the federal policy,

consistent with international usage, of avoiding or mitigating international double taxation.

Moreover, the Solicitor General also emphasized the fact that a state tax such as California's "is still invalid because it impairs federal uniformity" insofar as "it prevents the federal government from 'speaking with one voice' in international trade." Appendix F at A-20. In this respect, he noted, in terms that apply equally to the California levy at issue here, that:

> [T]he United States and most foreign countries use the arms-length method of allocating income between corporations. Illinois' variant unitary method impairs the otherwise uniform international custom that is the basis of the treaties between the United States and numerous foreign countries that are intended to prevent international double taxation of income. *Id.*

Finally, the Solicitor General concluded, *Id.* at A-21:

> In sum, "the freedom of the States to formulate independent policy in [the] area [of commerce] may have to yield to an overriding national interest in uniformity" *Moorman Manufacturing Co. v. Bair, supra,* 437 U.S. at 280. . . . The income taxation of multinational businesses is thus a matter that is subject only to a national rule conformable with the practice of nations or adopted pursuant to the President's authority "by and with the Advice and Consent of the Senate to make Treaties * * *" or Congress' power "[t]o regulate Commerce with Foreign Nations * * *." "[Illinois], by its unilateral act, cannot be permitted to place these impediments before this Nation's conduct of its foreign relations and its foreign trade." *Japan Line, Ltd. v. County of Los Angeles, supra,* 441 U.S. at 453.

If, as appellant submits and the Solicitor General has argued in his *amicus* memorandum, the Court concludes that the California combined reporting method either: (a) imposes international double taxation in fact, *or*

(b) impairs federal uniformity in the conduct of foreign relations, that is the end of the matter, and the judgment below should be reversed. In these circumstances, the California combined reporting method cannot be constitutionally applied to any multinational group of corporations—a result that appellant and the Solicitor General believe to be compelled by the commerce clause. See Appendix F at A-22.

To be sure, the United States "views the [case of the] foreign parent [corporation] with particular and special concern." Tr. 23. As the Solicitor General correctly pointed out, there are "other burdens that the state unitary method will impose on international trade and foreign relations," in the case of the foreign parent corporation. Appendix F at A-22. But under the analysis that proceeds from *Japan Line*, to which appellant and the Solicitor General both subscribe, there is no meaningful constitutional distinction between the case of a United States parent and its foreign subsidiaries and the case of a foreign parent with United States subsidiaries. In either situation, the combined reporting method is constitutionally prohibited if, as here, it results in international double taxation. What is more, the combined reporting method necessarily impairs federal uniformity, and is constitutionally prohibited, because it aggregates the income of commonly controlled entities in a manner that is sharply at variance with the internationally accepted arm's-length method of allocating income among related corporations.

II

BECAUSE THERE IS NO SUBSTANTIAL OPERATIONAL INTERDEPENDENCE BETWEEN CONTAINER AND ITS FOREIGN SUBSIDIARIES, THE DUE PROCESS CLAUSE PROHIBITS THE TAXATION OF CONTAINER AND THE FOREIGN SUBSIDIARIES AS A SINGLE UNITARY BUSINESS, REGARDLESS OF WHETHER OR NOT WORLDWIDE FORMULA APPORTIONMENT IN GENERAL IS PERMISSIBLE

It is a fundamental constitutional principle that the due process clause prohibits a state from taxing value earned outside its borders. The taxing power exerted by a state must bear a substantial relation to the protection, opportunities, and benefits provided by a state. Thus, the "simple but controlling question is whether the state has given anything for which it can ask return." *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940).

In the present case, California asserts a right to include in the apportionment formula income earned by subsidiaries of Container operating entirely in foreign countries. However, California cannot include the subsidiaries' income in the apportionment formula unless Container and its foreign subsidiaries possessed such substantial operational interdependence that they constitute a single unitary business under the criteria enunciated by this Court. As this Court has recently reiterated, "[t]he 'linchpin of apportionability' for state income taxation of an interstate enterprise is the 'unitary-business principle'." *ASARCO Inc. v. Idaho State Tax Commission*, ... U.S. ....; 50 U.S.L.W. 4962 (1982) (Slip Op. at 11, *quoting Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 223 (1980), in turn quoting *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439 (1980)). The facts of the present case compel the conclusion that, especially under the criteria set forth in the Court's recent decisions in *ASARCO*

and *F. W. Woolworth Co. v. Taxation & Revenue Dept.*, ... U.S. ....; 50 U.S.L.W. 4957 (1982), Container and its foreign subsidiaries do not operate as a single unitary business and California's combination of them is prohibited by the due process clause.

This Court has recently decided several cases in which various states have asserted that a unitary business existed. In two of the cases, "the states prevailed because it was clear that the corporations operated unitary businesses with a continuous flow and interchange of common products." *ASARCO,* Slip. Op. at 22, n.24. In *ASARCO* and *Woolworth,* however, because "these essential factors [were] wholly absent," the Court found that the businesses involved were not unitary. *Id.; Woolworth* Slip. Op. at 16-17. Here too there is no continuous flow and interchange of common products between Container and its foreign subsidiaries, and because "the parent company's operations are not interrelated with those of its subsidiaries so that one's 'stable' operation is important to the other's 'full utilization' of capacity," Container and its foreign subsidiaries cannot be taxed as a single unitary business. *Woolworth,* Slip Op. at 15 quoting *Exxon,* 447 U.S. at 218.

Exxon, Woolworth, and *ASARCO* establish beyond peradventure that two or more corporations cannot be combined into a single unitary business unless there is a substantial operational interdependence between the operations of the corporations. Thus in *Exxon,* a vertically integrated company with a continuous flow of products within the United States, constituted a single unitary business because it was a "highly integrated business which benefits from an umbrella of centralized management and controlled interaction." *Exxon,* 447 U.S. at 224. Where there was no such functional integration, however, and none of the substantial operational interdependence which was evident

in *Exxon*, the Court found that a unitary business did not exist. *See ASARCO; Woolworth.*

The relationship between Container and its foreign subsidiaries is virtually identical to the relationship between Woolworth and its foreign subsidiaries. In both cases, the foreign subsidiaries engaged in the same general line of business as the parent. The operations of the subsidiaries were highly decentralized, so that the subsidiaries located in each particular country operated as fully integrated, self-sustaining business operations. Stip. ¶ 61, J.A. 30; *Woolworth*, Slip Op. at 9-10. Thus, in both cases, "*no phase* of any subsidiary's business was integrated with the parent's." *Woolworth*, Slip Op. at 10 (emphasis added).

Here there was an insignificant transfer of goods or products between Container and its foreign subsidiaries. In *Woolworth* there was apparently no transfer at all. Stip. ¶¶ 26, 141, 143, J.A. 15-16, 73, 74; *Woolworth*, Slip Op. at 15. In both cases, the management of the foreign subsidiaries had complete control over business decisions affecting their operations. Stip. ¶ 74, J.A. 39-40; *Woolworth*, Slip Op. at 12. Container's foreign operation staff consisted of only five people, three of whom devoted only part of their time to foreign operations, while Woolworth had one vice president who evidently devoted all of his time to acting as "liaison man" with the smaller foreign subsidiaries and occasionally contacting the major subsidiaries. *Id.* at 13, n. 16. The personnel departments of both Container's and Woolworth's foreign subsidiaries were fully independent operations, dedicated to recruiting and training nationals to fill positions at every level of the business. Stip. ¶¶ 79, 89, 95, 109, J.A. 42-3, 48, 51, 56; *Woolworth*, Slip Op. at 12.

In addition, there are a number of other items which the Court identified in *Woolworth* and *ASARCO* to which

the facts in the instant case are similar.[24] The overriding fact, however, as emphasized by the Court in both *Woolworth* and *ASARCO*, is that, as in the present case, "[e]xcept for the type of occasional oversight—with respect to capital structure, major debt, and dividends—that any parent gives to an investment in a subsidiary, there is little or no integration of the business activities or centralization of the management of [the corporations involved]." *Woolworth*, Slip Op. at 15.

Furthermore, the approach of the Court of Appeal in *Container* to the unitary issue was much like that of the lower courts in *ASARCO* and *Woolworth*. Thus, the Court of Appeal "in important part analyzed this case under a different legal standard" than the one adopted by this Court. *Woolworth*, Slip Op. at 8. As did its counterparts in the other two cases, the Court of Appeal in the present case relied heavily on Container's *potential* ability to operate the foreign subsidiaries as part of the unitary business. For example, the Court of Appeal noted that Container bought no raw materials or finished products from its subsidiaries and sold only small quantities of paperboard and raw materials (and no finished products) to its subsidiaries. Nevertheless, the opinion gave weight to the fact that the subsidiaries *could* have bought more materials from the

---

[24] There are, of course, some small differences between the *Woolworth* and *Container* cases. In some instances, the facts indicate that Container and its subsidiaries have fewer links between them. For example, in *Woolworth*, the parent and the foreign subsidiaries all used the same general "F.W. Woolworth" corporate name. Slip Op. at 14, n.22, while Container's foreign subsidiaries did not use the "Container Corporation of America" name. Stip. ¶ 25, J.A. 14-5. In other instances, the facts indicate that some links in the *Woolworth* case were even more tenuous than in the present case. For example, the foreign subsidiaries of Container did owe some money to the parent at the end of each of the years in question and a very small number of Container employees had transferred to the foreign subsidiaries.

parent.[25] J.S. at A-8, A-9. Additionally, while the Court of Appeal did not dispute the fact that the foreign subsidiaries controlled their own operations and set their own policies, the Court emphasized that important decisions were "subject to" review by Container's management and seemed to give this potential review the same significance as if Container had made the decisions itself. J.S. at A-3.

This Court has made clear that the *potential* ability to operate a company as part of a unitary business is not dispositive, but that the companies must be operated as an integrated enterprise in fact. *Woolworth*, Slip Op. at 7-8; *ASARCO*, Slip Op. at 15-16. The Court noted that in *Woolworth* "[d]ecisions about major financial decisions, such as the amount of dividends to be paid by the subsidiaries and the creation of substantial debt, had to be approved by the parent." *Woolworth*, Slip Op. at 14. However, this review, and the potential for control which it may entail, did not warrant combination as a unitary business.

The "different legal standard" used by the Court of Appeal in this case extended considerably beyond its use of *potential* unitary ties as its yardstick. In reaching its

---

[25] In some instances, the Court of Appeal went beyond even *potential* unitary features, reasoning that a decision not to integrate operations was an indication that a unitary business existed. The Court of Appeal, in listing what it believed were features indicating operational unity, thus refers to the fact that the foreign subsidiaries "followed" Container's "policy of regional decentralization." J.S. at A-12; *see also* J.S. at A-2. Even if there was any evidence that the parent imposed such a standard on the subsidiaries (which there was not), the Court of Appeals position would lead to the absurd conclusion that if the parent "imposed" anarchy on the foreign subsidiaries as a management philosophy, such anarchy would be an indication that a unitary business existed. This confusion of the "potential" unitary feature of control with true functional integration has been rejected in *ASARCO* and *Woolworth*, since "[t]he state court's reasoning would trivialize [the] due process limitation." *Woolworth*, Slip Op. at 8.

conclusion, the Court of Appeal also failed to require the existence of meaningful, operational relationships between Container and the f reign subsidiaries and relied instead, at least in part, upon an administrative presumption that corporations engaged in the same line of business are unitary.[26] *Woolworth* and *ASARCO* clearly indicate that, just as the potential for a unitary business is not a justification for combination, an administrative presumption cannot be used as a basis for combining corporations into a single unitary group.[27]

In sum, both *Woolworth* and the instant case fall on the same side of the "critical distinction" set out by the Court in *Woolworth:*

> There is a critical distinction between a retail merchandising business as conducted by Woolworth and the type of multinational business—now so familiar—

---

[26]In this connection the court stated as follows:

> Appellant engaged in the same business activities as its subsidiaries. The administrative regulations indictate that a strong inference of a unitary business exists where the taxpayer is engaged in the same type of business. This administrative construction of the California tax laws "is entitled to great weight, and the courts generally will not depart from construction unless it is clearly erroneous or unauthorized."

J.S., A-15-A-16 (footnote and citations deleted). The relevant administrative regulation, Title 18, California Administrative Code, § 25120(b) is set forth in full at J.S., A-39-A-40. The relevant portion is quoted in footnote 4 to the lower court's opinion. J.S. A-15-A-16.

[27]Furthermore, other decisions of the Court indicate that, as in the present case, an opposite presumption is required. As demonstrated at pages 11-18, combination of Container and its foreign subsidiaries into a single unitary group results in a substantial misattribution of income to California. As a result of this strong evidence of distortion, at a minimum the state is required to counter the evidence. Absent such rebuttal, a presumption arises against the state's apportionment. This was precisely the approach taken by the Court in *Norfolk & Western Ry. Co. v. Missouri State Tax Commission,* 390 U.S. 317 (1968).

> in which refined, processed, or manufactured products (or parts thereof) may be produced in one or more countries and marketed in various countries, often worldwide. In operations of this character there is a flow of international trade, often an interchange of personnel, and substantial mutual interdependence. The uncontradicted evidence demonstrates that Woolworth's international retail business is not comparable. There is no flow of international business. Nor is there any integration or unitary operation in the sense which our cases consistently have used these terms.

Woolworth, Slip Op. at 16-17 (footnote omitted). As noted above, Container's subsidiaries in each foreign country produced and marketed their own products in each country. As in *Woolworth*, "there is no flow of international business," *i.e.* no flow of goods, and no "substantial mutual interdependence." *Id.*

The Court's opinion in *Woolworth*, as well as its decisions in *Exxon* and *ASARCO*, indicate that, in the case of a manufacturing or mercantile business, there can be no unitary business without a "flow of trade" between the affiliated corporations. Prior state income tax cases before the Court involving the unitary issue in the context of a manufacturing or mercantile business have been cases in which there has been a substantial flow of goods or products between affiliated corporations.[28] In *ASARCO*, while the Court held that a substantial product flow alone did not mean that affiliated corporations were unitary (*see* the discussion of Southern Peru Copper Corp. at pp. 13-15

---

[28] *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978) (integrated manufacture and sale of animal feeds); *Butler Bros. v. McColgan*, 315 U.S. 501 (1942) (integrated wholesale business involving centralized purchasing of inventory); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924) (integrated manufacture and sale of ale); and *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920) (integrated manufacture and sale of typewriters).

of the *ASARCO* slip opinion), the Court indicated that a substantial transfer of product was essential to the unitary combination of manufacturing or mercantile enterprises. The Court stated that it had previously approved unitary combination of such businesses "because it was clear that the corporations operated unitary businesses with a continuous flow and interchange of common products." *ASARCO*, Slip Op. at 22, n. 24.

In the court below, Container urged that a "bright line" standard be adopted as a *sine qua non* for finding a business to be unitary, namely that, as to manufacturing or mercantile enterprises, there must be a substantial flow of goods. While this Court has adopted such a standard by implication in its recent cases, it is respectfully submitted that express adoption of the standard in this case would add much needed certainty to this area for lower courts, tax administrators and taxpayers alike. Such a standard has been adopted by courts in at least two states and has been advocated by the leading commentator in the area. *Commonwealth v. ACF Industries, Inc.*, 441 Pa. 129, 271 A.2d 273 (1970); *Ash Grove Cement Co.*, Or.T.R. (CCH) ¶ 203-221 (Or.Tax.Ct. 1977); Hellerstein, "Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business", 21 *Nat'l Tax J.* 487, 501-02 (1968).

Explicit adoption of a substantial flow of goods requirement would reflect the reason for the development of formulary apportionment. The use of apportionment originated in cases where there was such complete operational interdependence, evidenced by a flow of products or raw materials, that "[t]he legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." *Bass Ratcliff & Gretton Ltd. v. State Tax Commissioner*, 266 U.S. 271, 281 (1924). Hence, for enterprises such as those that manufactured goods in one state or

country and sold them in others, apportionment became a useful tool. However, in the absence of such basic operational interdependence, there is no need, and no justification, for apportionment. The reasons for this conclusion have been thoughtfully described as follows:

> [C]entralized operations may be a factor in the greater profitability of some larger enterprises, as compared with smaller businesses. But that is not the linchpin of formulary apportionment. The costs of these centralized operations can be spread by cost accounting methods regularly used by accountants for internal accounting, SEC registration statements, reports to regulatory agencies for rate making, and for other purposes. . . . The underlying point is . . . that such matters require a spreading of costs, which can be acceptably accomplished by distributing charges on a time, or gross volume basis, or by other workable methods, and do not involve the elusive effort to segregate profits between interdependent steps in operations, such as producing in one state and selling in another.
>
> Consequently, the non-operating functions of an enterprise, . . . although centralized, ought not lay the basis for holding the enterprise unitary. Not only is there no reason in the considerations which gave birth to formulary apportionment to push the technique to this point, but perhaps of greater moment is the fact that so broad a sweep of formulary apportionment tends to push distortion and misallocation to unacceptable levels.

Hellerstein, *supra* at 501-02.

The substantial flow of goods requirement has the further advantage of introducing an objective factor into an otherwise largely subjective determination as to whether the business is unitary. Adopting such an objective standard would reduce the number of cases in which it is necessary

to refer to more abstract factors such as centralized management and operations and the like. For example, under a substantial flow of goods requirement, Container and its subsidiaries could not be members of a single unitary business.

In any event, *ASARCO* and *Woolworth* require a holding that Container and its foreign subsidiaries are not members of a unitary business. Without the existence of a single unitary business, California's method of taxation violates the due process clause of the United States Constitution. Thus, California cannot apply its method of taxation to Container and its subsidiaries.

CONCLUSION

For the foregoing reasons, Container submits that California's system of worldwide combination on a unitary basis should be invalidated and the decision of the California Court of Appeal reversed.

Dated: July 30, 1982.

Respectfully submitted,

FRANKLIN C. LATCHAM
COUNSEL OF RECORD
PRENTISS WILLSON, JR.
JAMES P. KLEIER
Counsel for Appellant
Container Corporation of America

Of Counsel
MORRISON & FOERSTER

(Appendices follow)

Appendix A

Hourly Earnings Rates Translated into United States Dollars for Wage Earners in Manufacturing Industries[1]

Country	Sex	Year 1963	1964	1965
United States	MF	2.46	2.53	2.61
Australia	M	2.05	2.11	2.21
	F	1.43	1.49	1.54
Austria	MF	.55	.60	.65
Belgium	M	.74	.83	.90
	F	.45	.51	.56
Canada	MF	1.80	1.88	1.97
Ceylon	MF	.15	.15	.16
Chile	MF	.24	.30	.32
Colombia	MF	.30	.30	.23
Denmark	MF	1.17	1.27	1.43
El Salvador	MF	.28	.28	.29
Finland	MF	.81	.92	1.00
France	MF	.54	.58	.61
Germany	MF	.87	.94	1.03
Ghana	MF	.70	.76	.35
Greece	MF	.28	.31	.34
Guatemala	MF	.36	.36	.37
Ireland	MF	1.40	1.55	1.65
Israel	MF	.58	.64	.73
Italy	MF	.54	.59	.62
Japan	MF	.43	.48	.52
Korea	MF	.14	.09	.10
Mexico	MF	.48	.53	.56
New Zealand	MF	2.33	2.44	2.59
Norway	M	1.11	1.18	1.28
	F	.77	.83	.92
Peru	MF	.32	.35	.35
Philippines	MF	.23	.23	.22
Puerto Rico	MF	1.13	1.18	1.24
Sweden	MF	1.41	1.54	1.69
Switzerland	M	.98	1.06	1.14
United Kingdom	M	2.48	2.67	2.93

[1]Source: United Nations, *Monthly Bulletin of Statistics*, January 1968, Table 57 at 132, based on data from the International Labor Office.

M refers to wages of males, F refers to wages of females, and MF to a single composite figure. Figures normally include bonuses, cost of living allowances, taxes, social insurance contributions pay-

able by the employed person and, in some cases, payments in kind. They normally exclude social insurance contributions payable by the employers, family allowances and other social security benefits. In a few instances, family allowances and salaried employees have been included in the figures. The information published by the United Nations is stated in terms of the local currency, which we have translated into dollars by the applicable midpoint exchange rates (in most cases) published in the United Nations, *Monthly Bulletin of Statistics*, January 1969, Table 64 at 192. In those cases in which daily, weekly, or monthly wage rates are given in the U.N. figures, we have assumed an 8-hour day, 44-hour week or 190.5-hour month for conversion purposes, which we regard as highly conservative. The foregoing table omits some of the countries as to which information is provided, most of which are in the Soviet bloc. In all cases with respect to the countries omitted, the average hourly earnings are substantially below those of the United States.

Appendix B

Hourly Earnings Rates Translated into United States Dollars for Wage Earners in Manufacturing Industries[1]

Country	1974	1975	1976	1977	1978	1979	1980
United States	$4.42	$4.83	$5.22	$5.68	$6.69	$ 6.69	$7.27
Australia	2.98M	3.37M	3.34M	3.90M	4.21M	4.37M	5.16M
	2.51F	3.09F	3.13F	3.68F	3.96F	4.06F	4.78F
Austria	2.36	2.48	2.99	3.59	4.30	4.89	4.75
Barbados	.85M	1.00M	1.12M	1.32M	—	—	—
Belgium	3.47	3.65	4.44	5.30	6.40	7.12	—
Canada	4.41	4.98	5.71	5.83	5.77	6.37	6.85
Chile	.13	.13	.24	.42	.60	.77	1.18
Colombia	.37	.40	.45	.54	.65	.81	.93
Denmark	5.34	5.82	6.93	7.61	9.53	10.06	9.99
Ecuador	.43	.53	.65	.73	.79	—	—
El Salvador	.45M	.46M	.58M	.62M	.68M	.76M	—
Finland	2.69	3.01	3.56	3.63	4.00	4.71	5.14
France	1.89	2.19	2.24	2.63	3.40	3.99	4.09
Germany, F.R.	3.71	3.70	4.38	5.29	6.42	7.14	6.73
Greece	.93	.97	1.21	1.52	1.85	2.10	2.20
Guatemala	.44	.46	.49	.53	.60	—	—
Ireland	1.95	2.22	2.15	2.81	3.63	4.30	4.40
Italy	1.86	2.62	2.44	3.07	3.91	4.82	—
Japan	2.55	2.82	3.29	4.39	5.79	4.99	6.33
Korea	.33	.42	.56	.75	1.01	1.30	1.17
Malawi	.24	.23	.23	.26	.30	.33	—
Mexico	1.18	1.43	1.13	1.30	1.49	1.74	2.05
New Zealand	2.92	2.65	2.76	3.41	4.08	4.36	—
Norway	4.19M	4.68M	5.87M	6.57M	7.26M	7.60M	7.91M
	3.22F	3.65F	4.66F	5.25F	5.82F	6.12F	6.48F
Philippines	.24	.23	—	—	—	—	—
Spain	1.40	1.75	1.99	—	—	—	—
Sweden	4.98	5.43	5.84	5.50	6.51	7.26	7.47
Switzerland	4.03M	4.24M	4.62M	5.78M	7.36M	7.78M	7.40M
United Kingdom	2.62M	2.83M	2.65M	3.22M	3.97M	5.06M	6.35M
Venezuela	1.58	1.80	1.85	2.02	2.29	—	—

[1]Source: United Nations, *Monthly Bulletin of Statistics*, September 1981, Table 57.

M refers to wages of males, and F wages of females; in other countries single composite figures are given. Figures normally include bonuses, cost of living allowances, taxes, social insurance contributions payable by the employed person and, in some cases, payments in kind. They normally exclude social insurance contributions payable by the employers, family allowances and other social security benefits. In a few instances, family allowances and salaried employees have been included in the figures. The information published by the United Nations is stated in terms of the local currency, which we have translated into dollars by the applicable midpoint exchange rates (in most cases) published in the

United Nations, *Monthly Bulletin of Statistics*, September 1981, Table 62. In those cases in which daily, weekly, or monthly wage rates are given in the U.N. figures, we have assumed an 8-hour day, 44-hour week or 190.5-hour month for conversion purposes, which we regard as highly conservative. The foregoing table omits some of the countries as to which information is provided, most of which are in the Soviet bloc. In all cases with respect to the countries omitted, the average hourly earnings are substantially below those of the United States.

Appendix C

Percentage of U.S. Average Hourly Compensation, Adjusted for Estimated Differences in Productivity[1]

Country	1969	1970
Japan	40	40
West Germany	61	72
United Kingdom	65	68
Belgium	60	61
Canada	79	82
France	58	54
Italy	62	67
Netherlands	74	71
Sweden	72	74

The data presented by the study represents, for 1969 and 1970, respectively, the estimated percentage of U.S. hourly compensation required as the average in each country to produce a quantity of manufactured goods equivalent to that produced in the United States.

---

[1]Source: United States Tariff Commission, *Competitiveness of U.S. Industries* (T.C. Publication 473) at 30 (1972).

Appendix D

No. 283

The Embassy of Canada presents its compliments to the Department of State and has the honour to refer to its Notes No. 692 and 245 of 22 December, 1981 and 10 May, 1982, together with the exchange of letters between the Secretary of the Treasury for the United States of America and the Canadian Minister of Finance of 26 September, 1980 on the occasion of the signing of the bilateral convention with respect to taxes on income and capital.

The Embassy has been instructed to draw again the attention of United States authorities to Canada's concerns about the unitary tax apportionment method used by certain states in the United States to allocate income to United States offices or subsidiaries of international corporations based on the corporation's worldwide earnings. The Canadian Government continues to be of the view that this method results in inequitable taxation and imposes excessive administrative burdens on international companies doing business in those states. Under this method the profit of a Canadian company, for example, on its United States business is not determined on the basis of arm's-length relations, but is derived from a formula taking account of the income of the Canadian company and its worldwide subsidiaries, as well as the assets, payroll and sales of each of these.

For a multinational company with subsidiaries in different countries to have to submit its books and records for all of these companies to a state of the United States imposes a costly burden.

Against this background the Canadian Government welcomed the decision of the Justice Department to file an amicus curae brief before the Supreme Court concerning the appeal of the Chicago Bridge and Iron Company

against the use of the unitary tax method applied by the State of Illinois. The Embassy has now noted that another such case will be considered by the Supreme Court later this year involving an appeal by Container Corporation of America versus the Franchise Tax Board (California) (Case 81-523). The Embassy would wish the foregoing concerns of the Canadian Government to be drawn to the attention of the relevant United States authorities and would welcome these views being referred to in any representation that the United States Administration may be making to the Supreme Court.

The Embassy of Canada avails itself of this opportunity to renew to the Department of State the assurances of its highest consideration.

Washington, June 14, 1982

Appendix E

AMBASSADE DE BELGIQUE

The Embassy of Belgium presents its compliments to the Department of State and, on behalf of the Ten E.C. Governments, of which the Government of Belgium has now the presidency, it has the honor to forward the attached Note on the problems of the unitary method of taxation.

The Embassy of Belgium welcomes the opportunity to renew to the Department of State the assurances of its highest consideration.

Washington, D.C. June 29, 1982
[Seal]

Attached: Note

The Department of State
Washington, D.C.

UNITARY TAXATION

1. Our Governments refer to their Note on unitary taxation forwarded on their behalf to the Department of State on 30 October 1981 by Her Britannic Majesty's Embassy.

2. Our Governments remain firmly convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory.

3. As was pointed out in that Note, unless the same basic rules for calculating taxable profits are followed generally by the main trading nations it will be impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment.

4. Our Governments wish to draw the attention of the State Department to the case of Container Corporation of America vs Franchise Tax Board which we understand is to be heard in the Supreme Court of the United States during the October Term 1982, and urge as a matter of high priority that the Government of the United States should participate in this case as amicus curiae.

Appendix F

In the Supreme Court of the United States

October Term, 1981

No. 81-349

Chicago Bridge & Iron Company, Appellant

v.

Caterpillar Tractor Co., et al.

On Appeal From the Supreme Court of Illinois

Memorandum for the United States As Amicus Curiae

INTEREST OF THE UNITED STATES

The federal government is charged with the conduct of the Nation's foreign relations. To that end, the Constitution confers upon Congress the power "To regulate Commerce with foreign Nations * * *" (Article I, Section 8, clause 3) and authorizes the President, "by and with the Advice and Consent of the Senate, to make Treaties * * *" (Article II, Section 2, Clause 2). The watchword in the area of foreign commerce is federal uniformity. "In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power." *Board of Trustees* v. *United States,* 289 U.S. 48, 59 (1933).

The United States submits that the imposition of the Illinois income tax on the apportioned combined worldwide business income of a unitary group of related cor-

porations, including foreign corporations, impairs federal uniformity in an area where such uniformity is essential. The United States, like most countries, employs the arms-length method of allocating income among commonly controlled corporations, and this method is mandated in numerous treaties, to which the United States is a party, that are intended to prevent international double taxation. Under the arms-length method, the income of each corporation is computed on a separate accounting basis under the assumption that each member of the group must deal with other members as if they were wholly separate entities owned by unrelated interests. Cf. 26 U.S.C. 482, and Treasury Regulations promulgated thereunder. The arms-length method insures against artificial shifting of income and deductions among related businesses. The Illinois apportioned combined method of computing income that is at issue in this case, however, can result in the allocation of taxable income to a corporation that incurs a loss on a separate accounting basis computed in accordance with the arms-length method. Thus, a domestic corporation that operates at a loss and has no federal taxable income may be subject to state taxation on foreign source income earned by its foreign affiliates (*e.g.*, income of a foreign parent or income of a foreign subsidiary that the domestic parent has not repatriated). These sharp differences between federal and international tax policies, on the one hand, and state tax policies on the other, undermine the federal government's ability to "speak with one voice when regulating commercial relations with foreign governments." *Michelin Tire Corp.* v. *Wages*, 423 U.S. 276, 285 (1976).

Moreover, international double taxation can result if foreign source income subject to the state combined unitary method is also subject to tax in the foreign country in which it is earned. The federal tax laws provide a foreign tax credit in order to mitigate such international

double taxation. See 26 U.S.C. (& Supp. III) 901 *et seq.* States employing the worldwide unitary method, however, do not allow a credit for foreign taxes.

We are accordingly advised by the Departments of State and Treasury, the Department of Commerce, acting at the request of the Delegation of the Commission of the European Communities, and the United States Trade Representative, that a number of foreign governments have complained—both officially and unofficially—that the apportioned combined method empowered by Illinois and other states creates an irritant in their commercial relations with the United States. Retaliatory taxation may ensue, with consequent damage to international trade. Moreover, the method causes uncertainties because it differs from the federal arm's-length standard that is generally accepted in international practice and in bilateral income tax conventions. Since this case poses much the same constitutional problems as existed in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), in which we participated as amicus curiae pursuant to the Court's invitation, we believe that the same federal interest likewise mandates participation here.

DISCUSSION

The question presented in this state income tax case is whether Illinois' imposition of its income tax on the apportioned combined worldwide business income of a group of related corporations, including foreign corporations, violates the Commerce Clause.

* * * *

2. It is settled beyond question that "the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state as-

pects of interstate affairs." *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 460 (1959); *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 436-442 (1980). See also *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920); *Hans Rees' Sons* v. *North Carolina*, 283 U.S. 123 (1931); *Butler Brothers* v. *McColgan*, 315 U.S. 501 (1942); *Moorman Manufacturing Co.* v. *Bair*, 437 U.S. 267 (1978).

As the Court stated in *Mobil Oil Corp.* v. *Commissioner of Taxes, supra*, 445 U.S. at 439, "the linchpin of apportionability in the field of state income taxation is the unitiary-business principle" (footnote omitted). In accordance with this principle, the Court has upheld state apportionment formulas, like that of Illinois, which combine the income of several related corporations engaged in a "unitary" business. Income is allocated to the taxing state by multiplying the total net income of the enterprise by a percentage comprised of the average of the ratios of in-state property, payroll, and sales to total property, payroll and sales. See Section 304(a) of the Illinois Income Tax Act, (Ill. Rev. Stat. ch. 120) J.S. App. E16-E18; see also *United States Steel Corp.* v. *Multistate Tax Commission*, 434 U.S. 452, 475 n.25 (1978); *Exxon Corp.* v. *Wisconsin Department of Revenue*, 447 U.S. 207, 214 n.3 (1980); *Mobil Oil Corp.* v. *Commissioner of Taxes, supra*, 445 U.S. at 429-430 nn. 2-4. A unitary business is one in which all of the corporate constituents are involved in an economically functionally-related enterprise. As one leading commentator has observed, the "very essence of formulary apportionment [is] that where there are integrated, interdependent steps in the economic process carried on by a business enterprise, there is no logical or viable method for accurately separating out the profit attributable to one step in the economic process from other steps." J. Heller-

stein, *State and Local Taxation* 400 (3d ed. 1969). See also J.S. App. C11; *Butler Brothers* v. *McColgan, supra,* 315 U.S. at 508. *Hans Rees' Sons* v. *North Carolina, supra,* 283 U.S. at 133.

Here, it is not disputed that Caterpillar and its 25 subsidiaries constitute a unitary business enterprise, and the Illinois Supreme Court so concluded (J.S. App. C11-C12). Thus, if Caterpillar and its subsidiaries conducted their business solely within the United States, the foregoing precedents we have cited would establish that the Illinois combined apportionment method would pass muster under the Commerce Clause for purposes of allocating its income among the several states. But Caterpillar is not a domestic enterprise. On the contrary, it conducts a worldwide enterprise and "Commerce Clause scrutiny may well be more rigorous when a restraint on foreign commerce is alleged." *Reeves, Inc.* v. *Stake,* 447 U.S. 429, 438 n.9 (1980).

We submit that the Court's analysis in *Japan Line, Ltd.* v. *County of Los Angeles, supra,* 441 U.S. at 434, undermines the basis of the decision below and invalidates the unitary apportionment method as applied to multinational corporate groups.[4] In *Japan Line,* the Court struck down a

---

[4]*Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission,* 266 U.S. 271 (1924) has no bearing on the question presented here. That case involved the application of a New York apportionment formula to a single British corporation which manufactured its product in England and sold it in New York through branch offices. See *id.* at 282. The taxpayer did not conduct its business in multinational corporate group form. There was accordingly no occasion for the Court to consider the constitutionality of the combined apportionment method and its inconsistency with the arms-length method in a multinational corporate setting. Compare *Hans Rees' Sons v. North Carolina, supra,* 283 U.S. at 132-133, with *Mobil Oil Corp. v. Commissioner of Taxes, supra,* 445 U.S. at 438-439, 440-441.

California ad valorem property tax, as applied to a Japanese company's shipping containers, as unconstitutional under the Commerce Clause because it resulted in multiple taxation of the instrumentalities of foreign commerce, and prevented this Nation from "speaking with one voice" in regulating foreign trade and thus was inconsistent with Congress' power to "regulate Commerce with foreign Nations" (Article I, Section 8, Clause 3). In so holding, the Court pointed out that in the domestic context, "[t]he corollary of the apportionment principle, of course, is that no jurisdiction may tax the instrumentality in full * * *. The basis for this Court's approval of apportioned property taxation, in other words, has been its ability to enforce full apportionment by all potential taxing bodies" (441 U.S. at 447).

But the Court's ability to avoid multiple taxation by ensuring full apportionment in the domestic context has no counterpart in the international sphere. As the Court explained (441 U.S. at 447-448; footnote omitted)—

> [N]either this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value. If a State should seek to tax the same instrumentality on an apportioned basis, multiple taxation inevitably results. * * * Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though "fairly apportioned" to reflect an instrumentality's presence within the State, may subject foreign commerce "' to the risk of a double tax burden to which

> [domestic] commerce is not exposed, and which the commerce clause forbids.'" *Evco* v. *Jones*, 409 U.S. [91], at 94 [1972], quoting *J. D. Adams Mfg. Co.*, 304 U.S., at 311.

Apart from the risk of multiple international taxation, *Japan Line* rests upon a second ground—the need for federal uniformity in an area in which federal uniformity is essential. As the Court stated, "Foreign commerce is preeminently a matter of national concern" (441 U.S. at 448). Since "the Federal Government must speak with one voice when regulating commercial relations with foreign governments" (*Michelin Tire Corp.* v. *Wages*, 423 U.S. 276, 285 (1976)), "[t]he need for federal uniformity is no less paramount in ascertaining the negative implications of Congress' power to 'regulate Commerce with foreign Nations' under the Commerce Clause" (footnote omitted) (441 U.S. at 449). As the Court further pointed out (*id.* at 450-451) (footnotes omitted):

> A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdiction. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from "speaking with one voice" in regulating foreign commerce.

In determining whether a state tax in the international context is constitutionally valid, it is necessary to examine "whether * * * [it] creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments'" (441 U.S. at 451). For "[i]f a state tax contravene *either* of these precepts, it is unconstitutional under the Commerce Clause" (*ibid.;* emphasis supplied).

We submit that analysis of the Illinois tax under the principles of *Japan Line* requires the conclusion that the combined apportionment method, applied to a unitary business with foreign corporate constituents, is barred by the Commerce Clause. Like the ad valorem tax at issue in *Japan Line,* the Illinois tax violates both precepts discussed in that decision insofar as it creates a substantial risk of international multiple taxation and impairs federal uniformity in the conduct of foreign relations.[5] We turn now to an examination of the operation of the Illinois tax in the multinational corporate context.

a. *Risk of multiple international taxation.* As we have pointed out (*supra,* pages 8-9), the Illinois apportionment formula allocates income on the basis of payroll, property and sales. Thus, in order to determine what portion of the worldwide income of a unitary group of corporations is allocable to Illinois, the total worldwide income of all the corporations of the group is multipled by a fraction which

---

[5]Hence, there is no basis for the Illinois Supreme Court's conclusion (J.S. App. C18) that *Japan Line* is "obviously distinguishable" because "[t]his appeal does not involve the multiple taxation of items or instrumentalities of foreign commerce nor does unitary reporting affect Federal authority in governing foreign commerce." The same considerations of international multiple taxation and federal uniformity in the conduct of foreign relations upon which *Japan Line* rests are equally applicable to a state income tax.

is the arithmetic average of the three ratios of in-state payroll, property, and sales to total payroll, property, and sales. See *Mobil Oil Corp.* v. *Commissioner of Taxes, supra,* 445 U.S. at 429-430 n.4, 437 n.13.

The theory underlying the three-factor formula, and indeed, the basis for its acceptability for Commerce Clause purposes, is that a dollar of payroll or property spent or a dollar of sales made in one state, produces roughly the same amount of taxable income as a dollar so spent or sales made in another state. See J. Hellerstein, *supra,* at 539. While this assumption may be sound within certain constitutional tolerances in a homogeneous economy such as the United States and thereby provides a basis for the division of interstate income, there is no comparable assumption that can be made in allocating the income of a multinational group. As the amici Container Corporation (Br. 14-18) and the Union of Industries of the European Community point out (Br. 10-11), there are great differences between the cost of property and payroll in the several states, on the one hand, and abroad, on the other, especially in developing nations. These differences would shift a disproportionate share of the foreign source income of a multinational group to state taxation if the three-factor formula were used.

Moreover, state use of the unitary apportionment method, in contrasts to federal, and internationally accepted, use of the arms-length standard, creates a substantial risk of international multiple taxation. For example, if a U.S. subsidiary engages in transactions with its foreign parent (which otherwise engages in no U.S. business activity) on an arms-length basis and the U.S. subsidiary operates at a loss, no portion of the foreign parent's income would, under the arms-length standard, be subjected to federal income tax. At the federal level, therefore, there

would be no international double taxation because only the foreign country would subject that income to tax. Under the state unitary method, however, a portion of the foreign parent's income would be allocated to the U.S. subsidiary and would thus be subject to tax in the state. Accordingly, both the state and the foreign country would tax such apportioned income, thereby resulting in international double taxation of the same income. In this manner, the state unitary method frustrates the federal policy, consistent with international usage, of avoiding or mitigating international double taxation.[6]

To be sure, the application of the Illinois tax in this case does not, as the California tax in *Japan Line*, "creates multiple taxation in fact" (see 441 U.S. at 452 n.17). Indeed, the unitary method has produced a refund for Caterpillar, a fact which explains its support of Illinois' position here. But we believe that the foregoing considerations demonstrate that the Illinois tax would, in most cases, create a substantial risk of international multiple taxation that would be sufficient to invalidate the unitary method in the international context. It would nevertheless be understandable if the Court wishes to resolve the issue in a case with a more fully developed record in which the state tax can be shown in fact to impose multiple burdens. This course of action may be appropriate insofar as the Court has not decided "under what circumstances the mere *risk* of multiple taxation would invalidate a state tax, or whether this risk would be evaluated differently in foreign, as opposed

---

[6]As we have pointed out (*supra*, page 3), the federal income tax law mitigates international double taxation through the foreign tax credit. See 26 U.S.C. (& Supp. III) 901 *et seq.* Under these provisions, foreign income taxes that are imposed on foreign source income that is also subjected to U.S. taxation can be credited against that U.S. tax liability. In marked contrast, the state unitary method at issue here has no comparable provision.

to interstate, commerce." *Japan Line, Ltd.* v. *County of Los Angeles, supra,* 441 U.S. at 452 n.17 (emphasis in original). Accordingly, if the Court wishes to consider the question in this case in the context of a case involving multiple taxation in fact, it may wish to defer decision in this case and note probable jurisdiction in *Container Corporation of America* v. *Franchise Tax Board,* No. 81-523.

b. *Federal Uniformity.* Even assuming arguendo that there is an insufficient showing in this case that the Illinois unitary method creates a risk of international multiple taxation, the tax is still invalid because it impairs federal uniformity. Under *Japan Line,* a state tax is invalid if it prevents the federal government from "speaking with one voice" in international trade, "[I]f it be otherwise, a single State can, at her pleasure, embroil us in disastrous quarrels with other nations." *Chy Lung* v. *Freeman,* 92 U.S. 275, 280 (1875).

As we have pointed out (*supra,* page 2), the United States and most foreign countries use the arms-length method of allocating income between corporations. Illinois' variant unitary method impairs the otherwise uniform international custom that is the basis of the treaties between the United States and numerous foreign countries that are intended to prevent international double taxation of income. Indeed, the Secretary of the Treasury and the Secretary of State have recently received diplomatic communications from the Governments of Great Britain and Canada, complaining about the state unitary method and emphasizing its incompatibility with international practice (see Appendix, *infra,* 1a-9a). Similarly, as appellant points out (J.S. 20), all nine members of the European Common Market joined in a *demarche* emphasizing the incompatibility of worldwide combined reporting with internationally accepted rules and principles of the OECD. "The risk of re-

taliation by [foreign countries], under these circumstances, is acute, and such retaliation of necessity would be felt by the Nation as a whole" (footnote omitted) (*Japan Line, Ltd.* v. *County of Los Angeles, supra,* 441 U.S. at 453). In this respect, the amicus Union of Industries of the European Community (Br. 7-9) points out that the application of the state unitary method may violate certain treaties of friendship, commerce and navigation. See especially Article IX of the Convention with France which limits state taxation of French companies to income " 'directly related to their activities within those territories' " (Br. 9 n.12).

In sum, "the freedom of the States to formulate independent policy in [the] area [of commerce] may have to yield to an overriding national interest in uniformity" *Moorman Manufacturing Co.* v. *Bair, supra,* 437 U.S. at 280. "We cannot have trade and commerce in world markets and international waters exclusively on our terms, governed by our laws, and resolved in our courts." *Bremen* v. *Zapata Off-Shore Co.,* 407 U.S. 1, 9 (1972). The income taxation of multinational businesses is thus a matter that is subject only to a national rule conformable with the practice of nations or adopted pursuant to the President's authority "by and with the Advice and Consent of the Senate to make Treaties * * *" or Congress' power "[t]o regulate Commerce with Foreign Nations * * *." "[Illinois], by its unilateral act, cannot be permitted to place these impediments before this Nation's conduct of its foreign relations and its foreign trade." *Japan Line, Ltd.* v. *County of Los Angeles, supra,* 441 U.S. at 453.[7]

---

[7]*Mobil Oil Corp. v. Commissioner of Taxes, supra,* 445 U.S. at 425, upon which the decision below relied (J.S. App. C18), has no bearing on this case. There, the Court held that a New York corporation having a place of business in Vermont could not object, on Commerce Clause grounds, to the imposition of a Vermont corporate income tax which allocated a portion of foreign source

3. If, as we submit, the Court concludes that the Illinois combined reporting requirement either: (a) creates a substantial risk of international multiple taxation, or (b) impairs federal uniformity in the conduct of foreign relations, that is the end of the matter, and the judgment below should be reversed. In those circumstances, the Illinois combined reporting method could not be constitutionally applied to any multinational group of corporations—a result we believe to be compelled by the Commerce Clause. If the Court concludes, however, that the record in this case is inadequate to support such a disposition, we urge it to defer resolution of the issue to another case which has a more fully developed record.

Whatever ruling it may render here, the Court should be aware that neither this case nor any case presently pending before it presents the issue in the context of a unitary business consisting of a U.S. subsidiary whose parent corporation is foreign. It may well be that the multiple tax burdens and the impairment to federal uniformity in international trade caused by the state apportionment method will be more easily demonstrated in a case involving a corporate group with a foreign parent. In that case, there will be, in addition to the considerations we have already pointed out, other burdens that the state unitary method will impose on international trade and foreign relations. For example, a foreign parent corporation with no direct U.S. activities would generally maintain its financial accounts according to local (*i.e.* foreign) accounting principles and in the local currency. Conversion of such accounts to conform to U.S. accounting principles and to the individual states' tax ac-

---

dividend income paid by its foreign subsidiaries. The taxpayer, however, admitted that New York, as the state of commercial domicile, could tax such foreign-source dividends in full. Hence, *Japan Line* was not implicated because there was no issue of international multiple taxation (see 441 U.S. at 446-447, 448).

counting rules, as well as conversion of all entries into U.S. dollars (which are required for apportionment under the state unitary method), pose a severe administrative and financial burden on the foreign parent corporation and other foreign affiliates. Moreover, there will be further burdens on international trade resulting from the demands by state tax authorities that the foreign corporation produce and explain its records of business transactions that are entirely unrelated to activities within the United States. Accordingly, the Court should not decide this case on any ground that would foreclose any claims that may be raised in a future case involving the imposition of the combined reporting method to a group of corporations with a foreign parent.

CONCLUSION

For the reasons stated, the judgment of the Supreme Court of Illinois should be reversed.

Respectfully submitted.

REX E. LEE
Solicitor General

STUART A. SMITH
Assistant to the Solicitor General

JANUARY 1982